

THE FREEMAN

IDEAS ON LIBERTY



**How Gold Was
Money—
How Gold Could Be
Money Again**

The Forgotten Private Banker

**First-Class Mail,
Third-Class Competition**

**The Prejudice Against
Midnight Dishwashing**

APRIL 1995

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IDEAS ON LIBERTY

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Economics 101—From Prison

Education, as the late Malcolm Muggeridge observed, has become the great mumbo-jumbo and fraud of our time. But prison, as it has through the ages, continues to teach invaluable lessons.

It was only when lying on rotting prison straw that Alexander Solzhenitsyn finally understood that the line between good and evil does not run between nations, political parties, or social classes, but right down the middle of every human heart. The great Russian writer would not have learned that essential truth in any American public high school, or even at Harvard, where he once received a rather frosty reception.

A more recent case in the United States brought home some lessons about the prison system itself.

Patrick J. Nolan was once the rising conservative star of the California Assembly, where he served as Republican leader. Mr. Nolan became embroiled in an elaborate FBI sting operation, in which the federal agency went so far as to establish a phony shrimp-processing company and even float phony bills in the California legislature. One of these bills passed and agents had to tell Governor George Deukmejian to veto the measure because it was a fake. This case itself is a lesson in how the government spends our money but there is much more.

Nolan was one of those who accepted contributions from the agent-entrepreneurs. While the details of the case would require a lengthy article, some Sacramento insiders believe Mr. Nolan is innocent. But after another high-profile target of the scam pleaded guilty, Mr. Nolan didn't like his chances and caved in. A lawyer with a degree from the University of Southern California, Mr. Nolan found his economic education continuing at the Federal Prison Camp in Dublin, California.

"It came as quite a shock to me," Mr. Nolan writes, "to learn that our judicial and penal systems are just like every other bureaucracy . . . [W]here was my healthy

suspicion toward government structures? Why did I think these agencies were exempt from the excesses of other parts of government just because I agreed with their aims?"

Like all bureaucracies, says Mr. Nolan, "the judicial-penal complex spends lavishly trying to convince us they are doing all they can to protect us and if they had a little more money they could get the job done."

Mr. Nolan realized that the system had a stake in expanding, not reducing, the number of people under its control. Hence, bureaucrats indulge a classic "bait-and-switch" operation in which they exploit the public's legitimate fears of violent crime as the basis for yet more spending. But Nolan notes that when they get the money, as they have in the recent Clinton crime bill, they don't target murderers, rapists, and muggers. Rather, says Nolan, "when the dollars are spent most go to combat a newly expanded list of non-violent, often unintended and, in fact, often quite innocent transgressions against the bureaucratic regulations and controls government increasingly imposes to hamstring the people." In fact, he says, "they go after non-violent criminals because they are easier to get." And here Mr. Nolan speaks from direct experience.

The former assemblyman noted that a "substantial portion" of his fellow inmates had been incarcerated for "bureaucratic 'crimes' arising from disputes with government employees over billing procedure, loan documentation, late filing of documents or other violations of statutes that are technical in nature." The message the system sends, he says is "submit to the bureaucrats

or be destroyed." And that process comes with a price.

"Bureaucrats and government lawyers," he adds, "consumed massive resources in prosecuting these men. Courtrooms were tied up for weeks while their cases were tried. Now they languish in prison, costing the taxpayers thousands of dollars for food, housing, and prison guards, not to mention the loss of their productivity to the economy." But on paper each conviction looks good, "like the body counts that came out of Vietnam."

Mr. Nolan also observed that government lawyers, prison builders and suppliers have done very well under the current system, which welcomes lock-'em-up measures such as "three strikes and you're out." According to the most recent figures, American prisons now house over one million inmates—a staggering, unprecedented number.

It would be easy to dismiss Mr. Nolan's rude awakening as a self-serving defense, but that would be to miss an important lesson, indeed, a challenge to his fellow conservatives. Says Mr. Nolan: "All government bureaucracies—even those founded to do things we like—not only tend to become self-perpetuating, they expand to serve those who work for them and do business with them."

It has seldom been put any better, even by someone not in prison. □

—K.L. BILLINGSLEY

Mr. Billingsley is a media fellow of the Pacific Research Institute in San Francisco.

How Gold Was Money— How Gold Could Be Money Again

by Richard H. Timberlake

1. Gold and Silver: The Money of the Constitution

Students, scholars, and some curious people who occasionally stray into the text of the U.S. Constitution are properly puzzled by what seems to be that document's "plain language" and some of the things they see around them in the world today. One such thing is the paper money and checks everyone uses to make ordinary transactions. The Constitution stipulates that, "No state shall . . . coin money, . . . or make anything but gold and silver coin a tender in payment of debts . . ." (Article I, section 10). Yet on every unit of paper money the U.S. government asserts without apology: "This note is legal tender for all debts public and private." By what political alchemy has gold and silver become paper?

Not only is the paper money legal tender, meaning that it must be accepted as payment for any debt owed by any person to another person or to a government, but the gold and silver specified in the Constitution are nowhere to be seen. Gold and silver coins rarely appear, and then only as collectible artifacts not as money.

Dr. Timberlake, this month's guest editor, is Professor of Economics Emeritus at the University of Georgia, Athens.

This seeming contradiction between the fundamental monetary law of the Constitution and real life conditions might suggest to a thinking person that gold and silver had somehow disappeared from the face of the earth in the 200-plus years since the Framers included that simple clause. However, such is not the case. The world's governments own more than 35,000 tons of gold as bullion and coin, and private persons own another (estimated) 50,000 tons. Silver is even more plentiful. Its current market price, reflecting its abundance, is only about one-eightieth the price of gold.¹

The absence of gold *money* correlates with the accumulation of gold hoards in the possession of government central banks and treasuries. If it's there, it obviously cannot be out in markets transacting business dealings, or in banks serving as a base for bank-issued notes and checks.

It was not always this way. Until the time of the Civil War in the United States, banks routinely held gold and silver as redemption reserves for their outstanding notes and deposits while the federal government held just enough to expedite its minting operations. Congress had the constitutional power to "coin money," but that power did not presuppose that it keep any stock of gold and silver beyond the inventory require-

ments of its mints. Indeed, even though Congress had the power it was not required to coin money at all. Private mints flourished until the Civil War, often minting coins of slightly greater gold content than government mints.

2. Paper Money and Gold after the Civil War

Civil War policies, however, changed fundamentally both the monetary system and the polity norms for governmental management of money. Congress authorized two new paper moneys, U.S. notes, or “greenbacks,” which were declared full legal tender, and national bank notes that were legal tender for debts due to and payment due from the federal government. For all practical purposes, both these issues of paper money were obligations that the U.S. Treasury had to redeem in gold on demand after 1879. In addition, silver money at the specified mint price began to decline in real value starting about 1875 due to the burgeoning supplies of silver from the American West, so that it, too, was a viable currency only because it was redeemable in Treasury gold. Gold held for monetary purposes in the 1880s and 1890s therefore became concentrated in the U.S. Treasury and sub-treasuries, whereas 50 years earlier several thousand commercial banks had held the gold to meet the demands of their local depositors and note holders.

The laws that authorized the three major fiat currencies changed the character of the gold standard from a widely dispersed gold standard, kept operational by thousands of local banks, to a “collectivist” gold standard operating from Washington and New York. Almost all the pressure for redemption of paper currency was transmitted to the U.S. Treasury and its sub-treasury offices. During the Panic of 1893, for example, the Treasury allowed its gold reserve to decline from \$259 million (average for 1892) to \$126 million (average for 1895), or by 51 percent.²

The Federal Reserve Act that Congress passed in late 1913 continued and aggra-

vated the centralization of gold. The Treasury still held gold as a reserve against its paper currencies outstanding, and the twelve new Federal Reserve Banks received the gold deposits of their “member” banks and gave them in return a bookkeeping reserve asset labeled “Reserve Bank credit.” Presumably, the member banks could get these deposits converted into gold whenever they needed it—much as an ordinary householder or businessman could write a check against his deposit at a commercial bank to get cash.

The events of World War I witnessed an extraordinary gold flow into the United States to pay for war materials and services. By 1922 total gold in the U.S. Treasury, including the amount held for the Federal Reserve Banks, was \$2,109 million, or 3,188 tons. Treasury gold fluctuated somewhat during the 1920s, but by 1929 was at \$3,278 million or 4,956 tons.

3. New Deal Gold Policy: The Government’s Great Hoard of Gold

As the Great Contraction began in 1929, the Treasury and Fed *increased* their hoards of gold—as though the stockpiling of gold in government vaults would serve as some kind of magical panacea that would reverse the disastrous ongoing contraction of money, bank credit, and employment. By 1931, Treasury gold was \$3,696 million—over 5,500 tons, while commercial banks were failing literally by the thousands for want of reserves.

The compulsion of the U.S. Treasury and Federal Reserve Banks to hoard gold between 1929 and 1933 was in sharp contrast to Treasury policy between 1892 and 1896. In the earlier period the Treasury felt duty-bound to redeem its paper currencies with gold and in so doing lost over 50 percent of its gold reserves. All through the 1929–1933 period, except for a brief interval in the middle of 1932, the Treasury and Fed added to their gold holdings while the banking system collapsed as its reserves disap-

peared. The net change in Treasury gold holdings was a minuscule decline of 1.8 percent.³

Given the gold flow into the United States at this time, the commercial banks would have had significantly greater reserves for redemption purposes and credit expansion if the Treasury and Federal Reserve had not existed! Rather than an "engine of inflation," the Federal Reserve System at this time was an absorber of gold and an "engine of contraction." Between 1929 and 1933 it allowed the economy's monetary stock of hand-to-hand currency and bank deposits to decline from \$26.2 billion to \$19.2 billion, or by 27 percent.⁴

Instead of relieving the depressed monetary and credit conditions of 1933 by getting the gold out of the hands of the Treasury and Federal Reserve Banks and into commercial banks and households, New Deal monetary legislation only made matters worse. Congress and the Roosevelt Administration passed several acts in 1933–1934 that added more gold to the government's holdings and at the same time induced the surviving banks to be even more squeamish about extending new credit. On May 12, 1933, Congress passed the Thomas Amendment to the Agricultural Adjustment Act. This provision, among other things, gave the President the power to raise the dollar value of gold by 60 percent. Then on June 5th, three weeks later, Congress passed the Act Abrogating the Gold Clause, which repudiated all gold clauses in all contracts public and private, including the bonds issued by the government itself to help finance World War I.

Next came the expropriation of privately held gold. By the Gold Reserve Act of January 30, 1934, President Roosevelt called into the U.S. Treasury all domestically owned gold and paid for it at the official mint price of \$20.67 per ounce. Then, by the fiat power of proclamation given to him in the Gold Reserve Act, he raised the mint price of gold by 59 percent to \$35 per ounce. Since the government now owned all of the gold, none of the "profit" from the gold price increase went to private house-

holds, to banks, or to business firms where it was desperately needed. Rather it enhanced the already bloated hoard of gold in the U.S. Treasury. Treasury gold, which was valued at \$4,033 million in *January* 1934 was accounted at \$7,438 million in *February* 1934!⁵

The political uncertainty in Europe, in addition to the enhanced price of gold in the United States, caused significant exports of gold to the United States in the 1930s. By 1941, Treasury gold had reached \$23 billion, which even at the new price amounted to over 20,000 tons! At the same time, private persons and businesses by the Act of 1934 were not allowed to own gold or to use gold for monetary purposes. And certainly the Treasury gold was not their gold.

4. Treasury Gold Policy after World War II

The gold in fact had become nothing more than a balance sheet adornment for the Treasury Department and the Federal Reserve Banks. Government spokesmen dishonestly claimed that the Treasury's hoard of gold "backed" Federal Reserve Banks' notes and reserves. But what does "backed" mean if no one is allowed to own or use the gold? It meant in this case that the U.S. government through its Federal Reserve Banks could issue almost as much paper money as it pleased.

Paradoxical as it might seem, foreigners, unlike U.S. citizens, could legally claim the U.S. Treasury's gold through their central banks and treasuries. Consequently, in accordance with balance of payments adjustments in the 1950s and 1960s, more than half of the Treasury's gold stock was exported to other countries. This continued outflow prompted President Nixon to discontinue even the pretense of a gold standard. On August 15, 1971, he barred any further gold redemptions to foreigners who held dollar claims. The price of gold then became an object of world market forces, but the U.S. Treasury holding since 1971 has remained almost constant at around 260 million ounces, or 8,125 tons.⁶

5. Why the Gold Should Be Separated from Government

What should be done with all this gold—the 8,000-plus tons the U.S. Treasury holds as well as the other 27,000 tons that other governments sequester? It seems obvious from the history of the relationship between gold and the state that the more gold there is in the hands of governments the less surely the gold serves as money. Therefore, the only way to restore gold and silver as media of exchange is to get the metals out of the possession and control of governments.

Certainly the gold has no current monetary or fiscal function for its government owners. It generates no revenue of any sort. It has no effect whatsoever on central bank monetary policies nor on the credit volume of the private banking system. In its present status as a government-owned “surplus” commodity, it is the “barbarous relic” that John Maynard Keynes characterized it in 1923. It may serve in the minds of Treasury bureaucrats as psychological starch for something or other that the government does, but the role it could play, and did play in earlier eras, as a viable money is completely absent.⁷

The gold cannot be forced into a monetary role. No government, including especially the U.S. government, is going to re-establish a gold standard by specifying the gold content of gold coins and declaring them legal tender. Treasury spokesmen would claim with some validity that it would be impossible to estimate the gold value of the current Federal Reserve dollar. They would argue that the indeterminacy of gold’s monetary value was a good excuse for doing nothing. So the gold would lie there, a useless heap similar in its non-function to other surplus commodities the government has stockpiled.

Even if the Treasury went through the formality of giving dollars a fixed gold value, it would insist on keeping the gold in the Treasury’s vaults in order to “back” the existing monetary aggregates that would now be “based” on gold. Central bank

policies would continue to operate much as they do today. Rather they would now have an undeserved aura (literally) of respectability behind which Treasury and Federal Reserve managers could conduct business as usual.

Therefore, sound money advocates should not waste their resources lobbying for a gold *standard*, which by definition would include the state as overseer and manager of a gold currency, specifier of a gold price in terms of dollars, custodian of the gold, and continuing manipulator of a central bank-issued paper money.

No. The only way to ensure that gold becomes a viable money is first to separate the gold from the state and the state from any further role in the operation of a gold money. Indeed, the separation of gold and the state would begin as an economizing measure—a form of privatization. Here are all those thousands of tons of gold lying idle and useless. Give them back to the people from whom the gold was unconstitutionally snatched in 1934.

6. Redistributing the Treasury Gold to the People

The Treasury Department collects and disburses money for the federal government through its Internal Revenue Service (IRS). In some given taxable year, say 1996, the IRS would note the total number of dependents on the various income tax forms—1040, 1040A, and 1040 E-Z. It would then issue one one-ounce gold certificate for each listed dependent to the heads of households who had filed the returns.

The stored gold is in the form of ingots each of which weighs 400 troy ounces (27-plus pounds), and is worth somewhat more than \$15,000 at the current market price of gold. The Treasury would offer to exchange (sell) these bars in the open market for the appropriate number of gold certificates to any private firm or individual tendering them in the proper quantities. It would leave the actual disposition of the gold completely in the hands of private wholesalers and brokers.

In order to get the gold bars from the Treasury, a wholesaler would have to collect enough gold certificates to make his effort worthwhile. Very quickly, the gold market would establish a dollar price for the gold certificates. The price would be slightly less than the spot gold price currently posted in markets because the wholesaler-distributor would have to get some return for his services, which would include shipping, handling, storing, and packaging the gold.

Taxpayers who received the gold certificates would be elated. After all these decades of paying taxes, they were finally getting something in return. True, it would be far less than what they had paid in, but at least the gesture would reflect a disposition on the part of a grateful government to reward its supporters by returning to them some real wealth that the government cannot use and that cost it nothing in the first place.

The new gold owners—virtually all of us—would next ponder what to do with their windfalls. Some would at first want to deposit their gold certificates in banks as gold demand accounts until they were more certain of its value and utility to them. Because many people might want this option, banks would cater to their wishes by offering gold-deposit accounts distinct from conventional checking accounts. The banks would use the gold certificates to claim the gold bars from the U.S. Treasury, and the gold would then become a true reserve backing the gold demand deposits.

Industrial users would also want the gold to make art objects as well as other gold items. And some amount of the gold would probably be used in medical technology and the physical sciences.

Finally, some certificate holders might want to exchange their certificates for gold coins that would be something like the half-eagles, eagles, and double eagles of the pre-1914 era. (The double eagle was a “twenty-dollar gold piece” and contained slightly less than one ounce of gold.) To satisfy the demand for coins, private coin-smiths would buy bunches of one-ounce certificates from the taxpayers who had

received them and exchange them at Treasury offices for ingots. The coinage specialists would then produce coins in convenient denominations and sell them to their numismatic clients.

7. How the People's Gold Would Become Money

The gold redistribution would find everyone a winner. True, the U.S. Treasury would lose the gold. But since Treasury executives realized no travail in collecting the gold, and since the gold currently has no fiscal or monetary function to the government or any other use, parting with the gold should cause no more concern than clearing out obsolete records and other trash. Its departure would in fact markedly reduce the administrative costs of Treasury operations.

The now-privatized gold that had become the basis for special bank-administered checking accounts would develop monetary functions. Gold depositors who wished to transact in this medium would have checkbooks appropriately identified with gold logos, and would write checks to anyone who would accept title to the designated quantity of gold as payment for a debt. Gold reserve banks would clear gold balances with each other based on their daily or weekly debits and credits. They would perforce redeem deposits on demand in gold for any gold depositor who so wished. Eventually, borrowers might base their loans on gold, whereupon the gold would complete its restoration as a viable money.

Gold would not become *the* monetary standard. It would continue to have a dollar-price in the world's gold market but it would not have a mint price specified by Congress. No government department or bureau would own gold. Federal Reserve notes as currency and Federal Reserve Bank reserve-deposit accounts for commercial banks would still be the only legal tender (in spite of the Constitution) and available as they are now for those who want conventional fiat paper money. The gold would simply be an alternative money for people

who chose to use it for transactions and contracts.

8. The New Gold Money as a Check on Federal Reserve Policies

A final interesting feature of the privatized gold would be the effect of its market price in paper dollars on present-day Federal Reserve policy. Some responsible Federal Reserve officials on the policy-making Federal Open Market Committee (FOMC) are currently trying to implement a policy of long-term price level stability, that is, a policy of zero inflation. However, they are constantly badgered by monetary "activists" in Congress and the Administration who want the FOMC to revert to a short-run inflationary "cure" for unemployment and economic slumps. If the privatized gold became fairly widely used as money side-by-side with Federal Reserve fiat money, the price of gold in Federal Reserve dollars would tend to be an instant check on the state of inflation—much more so than it is today. When the market price of gold rose, everyone would know that the Fed was inflating—that the real value of the paper dollar was falling—and would substitute private gold money for Federal Reserve money. The market price of gold, therefore, would be a constant check on too much monetary activism by the FOMC. It would thereby contribute significantly to the Fed's desired policy of price level stability.

To achieve a gold-based money, the gold must be held ubiquitously so that individual people may endow the gold with monetary properties and monetary functions. But to

have this effect, the gold must be in everyone's possession so that everyone "can get the idea." For the last 60 years the Treasury has hoarded thousands of tons of gold, and has only disbursed it to foreign central banks and governments; and for the last 20-plus years the gold has been a largely inert mass of no use to anyone. Even Treasury officials are largely ignorant of its physical details. Suppose, however, that an astute politician promised to return the gold to the people as a means of economizing on the inventory of "surplus" government commodities. Can anyone imagine that such a plank in a political platform would be unpopular? "No, no," the candidate would declaim, "I am not buying votes with gold. I would not stoop to that. I simply want to economize government operations and, at the same time, return a useful commodity to the public so that people can use it as money if they wish to do so."

Yes, Mr. Candidate, you have my vote. □

1. Lewis Lehrman and Ron Paul, *The Case For Gold*, Washington: The Cato Institute, 1982, pp. 160–161.

2. Richard H. Timberlake, *Monetary Policy in the United States*, Chicago: University of Chicago Press, pp. 158–159.

3. *Ibid.*, pp. 280–281.

4. Milton Friedman and Anna J. Schwartz, *A Monetary History of the United States, 1867–1960*, National Bureau of Economic Research, Princeton: Princeton University Press, 1963, pp. 712–713.

5. Timberlake, *ibid.* Also, Horace White, *Money and Banking*, rev. and encl. by Charles Tippets and Lewis Froman, New York: Ginn & Co., 1935, pp. 696–721.

6. Paul & Lehrman, *The Case for Gold*, pp. 159–161.

7. Treasury officials and other government spokesmen often speak reverently about the "country's gold reserves." This reference is at least 66 $\frac{2}{3}$ percent inaccurate. The gold does not belong to the "country"; it belongs to the federal government. And the gold is not a "reserve" for anything. It is an inert stockpile of precious metal. I do not doubt, however, that it is truly gold, and that it exists. Nevertheless, I would like a little more on-the-spot confirmation of this presumption.

New from FEE!

THE LUSTRE OF GOLD

The seventeen essays in this collection examine the rejection of gold, the history of the gold standard and private coinage in the United States, and the prospects for monetary reform. Contributors include Hans F. Sennholz, Mark Skousen, Henry Hazlitt, Elgin Groseclose, Robert G. Anderson, and Lawrence W. Reed.

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The Forgotten Private Banker

by Richard Sylla

What is a private banker? Or rather, since the species has more or less disappeared, what was a private banker? Private bankers, to American banking historians, were individuals and organizations that engaged in the business of banking without first obtaining a permit to do so from governmental authorities. As a consequence, the private banker often was free to practice the banking trade with little or no governmental regulation. That was one of the private banker's principal advantages. But it also became a leading reason for the private banker's undoing and eventual disappearance from the economic scene.

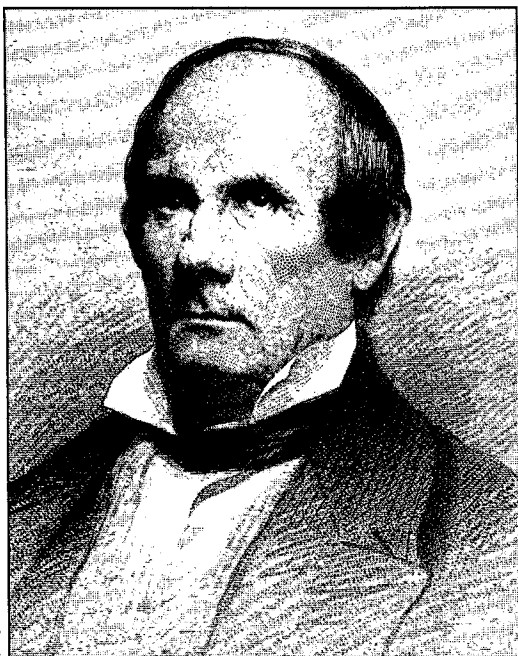
Today, when nearly every U.S. (and foreign) bank operates under a license from, and is regulated by, one or more governments, the idea that the provision of banking services could be left to market forces might strike many people as somewhat bizarre and perhaps even dangerous. Nonetheless, this idea was central to the development of the banks and banking systems of England and continental Europe during much of the seventeenth, eighteenth, and nineteenth centuries. The celebrated Rothschilds, for example, were private bankers, and so were all the banks of England—except the Bank of England—until the second quarter of the nineteenth century.

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Prominent U.S. Private Bankers

Given the new world's roots in the old, it is not surprising that the idea and the practice of unlicensed, unregulated banking would migrate to the United States. Indeed, a number of the leading figures and financial institutions in U.S. history were private bankers and banks. Alexander Hamilton was instrumental in founding the Bank of New York as a private bank in 1784, although less than a decade later the bank applied for and received a charter from the state of New York. This venerable American institution still carries on its business from its headquarters at 48 Wall Street. Across the street, at 59 Wall Street, is Brown Brothers Harriman & Co., the only remaining private bank of any size in the United States; it is the exception that probes the rule that banks ought to be licensed corporations. This bank began its career in Philadelphia in 1818 as the Merchant Bank of Brown Brothers, with representative branches in Baltimore and London. It moved its headquarters to New York in 1825.

At 60 Wall Street, next to the Bank of New York, are the headquarters of J. P. Morgan & Company. The Morgan bank is now a corporation, but it was a private bank during the time of its legendary founder, John Pierpont Morgan (1837–1913), and it remained so long after his passing. Another noted private bank was the Bank of Stephen Girard in Philadelphia. Girard, possibly the



James Guthrie (1792-1869)

wealthiest American of his era, operated this bank from 1812 until his death in 1831. Girard's bank took over the building of the first federal Bank of the United States after that institution passed out of existence in 1812. The structure still stands as a prominent feature of Independence National Historical Park in Philadelphia.

Extent of Private Banking

Most of America's private bankers were not as large or as prominent as the ones identified here. But they were quite numerous in U.S. history, especially in the early decades. In 1856, U.S. Treasury Secretary James Guthrie reported to Congress on a survey of the extent of private banking as compared with that of licensed, that is, "chartered" state banks. Guthrie found the capital of private bankers to be at least \$118 million, which was more than a third of the capital of the state-chartered banks. He went on to note, "The combined capital in chartered and unchartered banks being over \$460,000,000, proves that banking is a favorite as well as a profitable business, and does not need chartered privileges to gen-

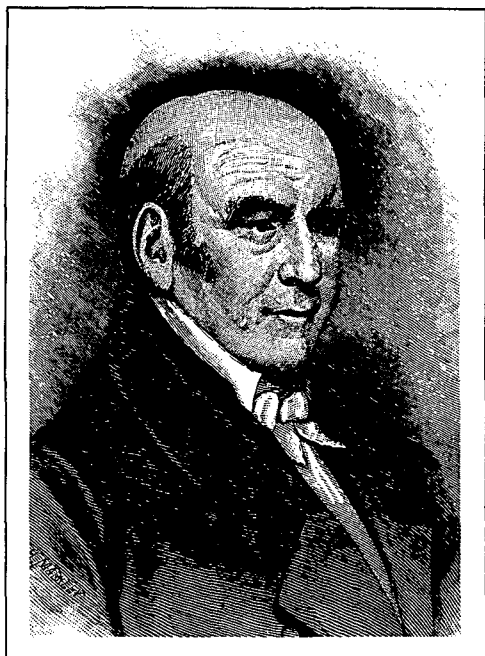
erate or protect it."¹ My own work on U.S. banking history in antebellum times led to an estimate of more than 700 private bankers operating in the country by the mid-1850s.² If the estimate is close to accurate, about one American bank in three was a private bank at the time.

Even then, however, private banking had entered a protracted period of relative decline that would in time lead to its virtual disappearance. Secretary Guthrie's statement to Congress that banking did not require "chartered privileges to generate or protect it" probably indicated that even by 1856 most people thought otherwise. Why?

Private Banking and the Public Interest

There are, it seems, two possible sets of answers to the question of why banks ought to be licensed and regulated by governmental authorities. One involves public interest arguments. If banks are not licensed by government, then there is a greater probability that scoundrels and crooks will enter the banking business. And without continuing governmental oversight by government-appointed bank examiners, such bankers would mismanage or even abscond with the funds entrusted to them by the public. Since each bank is a component of the banking and monetary system, a few such "bad" bankers could undermine, even destroy, the whole system, which is built on confidence.

These are microeconomic considerations. But they have obvious macroeconomic implications. A "crisis of confidence" in banking could cause a monetary collapse and plunge the economy into depression. At the other extreme, unregulated banks might flood the economy with money in the form of bank notes and deposits created by making excessive loans. Unsustainable inflation would result before the arrival of the inevitable collapse. To prevent either extreme of too little or too much money from happening, the argument goes, governments must regulate banks to provide just the right amount of money for sustainable, non-inflationary economic growth.



Stephen Girard (1750–1831)

There are problems with these public-interest arguments. It is not evident, for example, why customers would deal with, or allow themselves to be victimized by, scoundrels and crooks in banking more than in other businesses that are unlicensed and unregulated. Moreover, it is amply evident from history, even quite recent history, that governmental licensing and regulation have prevented neither individual bank frauds and failures nor depressions and inflations. But here I shall only mention these still vigorously debated issues without further exploring them. The so-called public-interest arguments in fact had little to do with the decline of private banking.

The Political Economy of Banking

The decline of private banking had far more to do with the self-interest of both government officials and the non-private banks they licensed and regulated than with the public interest. The United States of the 1780s and 1790s was both capital poor compared to the West European countries and free of the English laws that required banks

to be entities with unlimited liability and no more than six partners. In these circumstances, most early U.S. banks were institutions chartered by state legislatures as limited liability corporations. Attracted by limited liability, their owner-shareholders clubbed together their limited liquid funds to start the banks, through which they then made loans to each other and to non-owner customers. In return for their charters representing governmental authorization to provide banking services, the banks agreed to make loans to, and perform other services for, the states that granted them their charters. The states especially liked this arrangement after the adoption of the U.S. Constitution, for that document prohibited them from continuing the century-old practices of colonial, and then state, governments of issuing fiat paper money. Because of the Constitution, the states could no longer pay their bills by printing state paper money, but they could still charter banks that issued money.

The earliest state-chartered banks were thought of by legislators, shareholders, bankers, and the general public as public utilities. They were given exclusive privileges, namely monopolies of banking in their towns, in return for providing financial services to the state and the public. As the American economy grew and prospered, these state-chartered banking monopolies became highly profitable. Inevitably, new banks sought to enter the field to get their piece of the action, whereas those already in the field sought to keep out the would-be entrants. Resolution of these conflicting politico-economic pressures took several decades. The ultimate result in the leading commercial and industrial states was an American version of "free banking," which meant relatively free entry into banking provided the bank agreed to follow rules and regulations prescribed by state governments.

State legislatures and individual legislators thrived on the early American procedure of chartering banks individually by specific legislative acts. The grant of a bank charter gave the grantees a lucrative set of

privileges not possessed by others. Bank charters therefore had economic value. The states and the legislators were not oblivious to this fact. They responded to it by charging the banks for their charters. These charges sometimes took the form of bonus payments to the states when charters were granted or renewed. They also took the form of bank stock issued to state governments on favorable terms so that the states could share in bank profits. Other types of charges included special taxes placed on banks and of state directives to the banks to finance out of bank resources certain institutions (such as schools) that the states deemed worthwhile.³ These were above-the-board payments the states could demand of the banks in return for grants of charter privileges. They were popular because they kept down taxes on individuals. In addition, there were under-the-table payments to individual legislators for seeing that some banks received charters and that others did not. In state capitals, because of all these payments for privileges, bank chartering and state politics more or less became extensions of each other.

Enter the Private Banker

On account of all the political considerations involved in bank chartering, the number of chartered banks grew more slowly than it might have, given public demands for banking services. And for good reason. Charter values, and hence the payments that states and individual politicians could extract from banks, were greatly enhanced by restricting entry into banking. Restrictive chartering practices created a yawning gap for the private bankers. A demand for banking services was there, and growing. The chartered banks, the states' creatures, were not meeting the demand for politico-economic reasons that had little to do with economic efficiency. And nothing, at least for a brief time, prevented individuals and partnerships from plying the trade of banking without a license, just as private bankers long had done in England and Europe.

We do not know how many private bank-

ers entered the field. Their numbers must have been large, however, at least large enough to annoy both the chartered banks and the state legislatures. The former had paid for their charters; the latter had received the payments. Unauthorized competition in banking threatened to undermine this neat political arrangement.

Hence, between 1799 and 1818, no fewer than eleven states and the District of Columbia enacted laws to restrict private banking. The larger states, where private banking likely was most vigorous, acted on more than one occasion. New York passed four acts to restrain private banking between 1804 and 1818, Pennsylvania three, and Virginia two.⁴ The typical restraining act either banned private bankers from issuing their own bank notes, which was the primary method of providing bank credit at the time, or it laid a prohibitive tax on such note issues.

Such legislation served two politico-economic purposes. It reduced or eliminated competition for existing chartered banks, thereby raising the value of bank charters and the payments the states could extract for granting them. And it drove many private banks into applying for charters, so that they, too, would have to pay the tolls levied for governmental authorization to engage in banking.

Nonetheless, private banking persisted in the United States for decades. Privacy and minimal regulation were among its advantages, but the main reason for its persistence was that the states, and later the federal government, dragged their heels in chartering enough banks to satisfy the demand for banking services. American state governments and public officials were not inept in their slowness to charter banks. Both they and the banks already in the field had a financial interest in restricting banking development. That this interest was different from, and even inimical to, the real public interest was a small consolation to the private bankers. They were harassed by restraining acts and eventually driven out of banking or into "authorized" banking on terms set by government.

An Implication for Our Time

Although the private banker, with few exceptions, passed long ago from the economic scene, the history of U.S. private banking sheds light on quite recent events. In September 1994, the 103rd Congress enacted legislation to allow interstate banking. Thus, early in the third century of the republic, American banks at last obtained the freedom to do what flour millers, meat packers, and clothing manufacturers could always do, namely market their products throughout the country.

Why did it take so long? The fundamental reason, I think, is that in U.S. political economy banking is the last bastion of states' rights. Banking is the one area of regulated economic life in which the federal government almost always has deferred to the preferences of the states.

Federal deference to states' rights is unusual in American history. The Constitution transferred substantial but limited economic powers from the states to the federal government. During the first century of the republic, Congress and the federal courts used those powers to prevent the states from interfering with the emergence of a nationwide free trade area. And during the second century of the republic, right up to the present, the federal government further weakened states' rights through federal laws, regulations, programs, and mandates that, for good or ill, increased the political and financial clout of the government in Washington relative to the governments of the states.

Given this record, how did the states manage until 1994 to resist the federal juggernaut and maintain their power to regulate their own chartered banks as well as federally chartered banks operating within their boundaries, and to keep out banks chartered by other states? No doubt many reasons could be given. But underlying all of them must be this: Banking became the last bastion of states' rights because it was the first

bastion of states' rights to matter in government-regulated economic life.

Early in U.S. history, the financial interests of state governments and politicians became substantially wedded to the interests of the banks they had chartered. Because banking was the first great corporate interest to be regulated in our history, state governments and banks together were able to resist encroachments into their terrain by outsiders in ways that later corporate interests, less regulated and less intimately tied to state financial interests, were not. Private bankers as a class were only one of the trespassers on the intertwined interests of the state-chartered banks and the state governments that chartered them. The first and second Banks of the United States established by the federal government were likewise trespassers. Like the private bankers, the two federal banks were beaten down and, in 1812 and 1836, eliminated by powerful coalitions of state banks and state governments. In most areas the federal government discovered ways to override parochial state interests, but in banking it was itself overridden. Hence, the federal government learned the hard way to accommodate itself to state interests in banking, for a longer time than made much sense. The fragmented U.S. banking system, which continues to look peculiar when compared with the banking systems of other countries, is a result of the defeats suffered by both private bankers and the federal government in the early decades of the republic's history. □

1. U.S. Secretary of the Treasury, "Report on Banks," (1856), 34th Congress, 1st Session, House Executive Document No. 102, p. 1.

2. Richard Sylla, "Forgotten Men of Money: Private Bankers in Early U.S. History," *Journal of Economic History* 36, March 1976, pp. 173-88.

3. Richard Sylla, John B. Legler, and John Joseph Wallis, "Banks and State Public Finance in the New Republic: The United States, 1790-1860," *Journal of Economic History* 48, June 1987, pp. 391-403, and John Joseph Wallis, Richard E. Sylla, and John B. Legler, "The Interaction of Taxation and Regulation in Nineteenth Century U.S. Banking," in Claudia Goldin and Gary D. Libecap, eds., *The Regulated Economy: A Historical Approach to Political Economy* (Chicago: University of Chicago Press, 1994), pp. 121-44.

4. Sylla, "Forgotten Men of Money," p. 182.

The Failure of Central Banking in Developing Countries

by Kurt Schuler

Twenty-five years ago, most of the world's currencies were linked to the dollar by fixed or pegged exchange rates. (I will explain those terms later.) The system was known as the Bretton Woods system, named after the New Hampshire town where an international monetary conference establishing the system had been held in 1944. Although the dollar was far from perfect, it provided some discipline against inflation and thereby aided economic growth, especially for developing countries. From 1960 to 1970, average annual inflation in developing countries was 3–4 percent, about the same as in developed countries.¹ The rather spotty statistics of economic growth for developing countries indicate that growth per person was increasing roughly as fast as in developed countries.

The Bretton Woods system began to unravel in 1971 and collapsed completely by 1973. It unraveled because the U.S. government abandoned the policy of keeping the dollar convertible into gold at \$35.00 per troy ounce. Over the years the Federal Reserve System, the U.S. central bank, created money too fast to be compatible

with the government's stock of gold at the existing exchange rate. Foreigners therefore converted dollars into gold at a rapid rate, which reduced the U.S. government's stock of gold. Rather than replenish the stock of gold by having the Federal Reserve raise interest rates, the U.S. government decided to make the dollar a floating currency in terms of gold.

Other countries thought that they could do better by floating their currencies also, rather than maintaining pegged exchange rates with either the dollar or gold. At first it was mainly developed Western countries that floated their currencies. Over time, though, more and more developing countries also floated their currencies against the dollar.

After the collapse of the Bretton Woods system in the early 1970s, developing and developed countries alike experienced lower growth and higher inflation. From 1970 to 1980, average annual inflation was 9.1 percent in developed countries and 26.2 percent in developing countries. But since about 1980, developed countries have reduced inflation, while developing countries have not.

From 1980 to 1992 average inflation for developed countries fell to 4.3 percent a year, while for developing countries it accelerated to an astounding 75.7 percent. The result has been a slowdown in economic growth for developing countries. From 1980 to 1992, economic growth was 2.3 percent per person a year in developed countries, but only 0.9 percent in developing countries. The trend has continued since 1992. Only a few East and South Asian developing countries grew rapidly; many other developing countries actually had declining income per person.

Central Banks Responsible

The dramatic rise in inflation and fall in economic growth in many developing countries since 1971 has been caused by their

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central banks. Except in Latin America, few developing countries had central banks before the 1950s. Until then most developing countries were colonies of European countries, particularly Britain and France. The currencies of almost all developing countries were linked in one way or another to the dollar, pound sterling, or franc. The dollar, sterling, and franc all experienced difficulties before 1971, but even so they imposed a sort of quality control on the currencies of developing countries by means of exchange-rate links.

Before developing countries established central banks they had a variety of arrangements for maintaining exchange-rate links with the dollar, sterling, or franc. A few countries had free banking—competitive issue of banknotes by commercial banks—although government intervention ended that system before World War II in most places where it had existed. Other countries, including some French and Portuguese colonies, had monopoly issue of notes by a commercial bank that was granted the monopoly privilege by the government. Still other countries, mainly French colonies, had monetary institutes. A monetary institute is a government body that issues banknotes under fairly strict rules, such as a requirement that it have foreign reserves (bank deposits or high-quality bonds in a foreign currency) of 50 percent or more against its banknotes in circulation and other liabilities. Monetary institutes in French colonies were supervised by the French government, which kept a watchful eye on them because it did not want to pay for their mistakes.

Still other developing countries, mainly British colonies, had currency boards. A currency board is a monetary authority that issues banknotes and coins (and, in some cases, deposits) backed 100 percent by assets in a foreign “anchor” currency and fully convertible into the anchor currency at a fixed exchange rate and on demand. As reserves, a currency board holds low-risk, interest-earning bonds and other assets payable in the anchor currency, equal to 100 percent or slightly more of its bank notes

and coins in circulation (and deposits, if any), as set by law.

Although there were differences in the ways that these monetary systems worked, they shared two important features. The first was that all provided relatively low inflation by means of stable exchange rates to their anchor currencies or to gold or silver. The second feature, which was related to the first, was that all kept government away from the monetary printing press, through private ownership (in the case of free banking and monopoly issue of notes by a commercial bank) or strict rules governing monetary policy (in the case of the currency board and monetary institute systems).

The record of these pre-central banking monetary systems was very good. Devaluations happened occasionally except in currency board systems, but they were imposed by governments and were not the fault of commercial banks or monetary institutes. Most of the pre-central banking systems maintained full convertibility of their own currencies into their anchor currencies; that is, there were no restrictions on exchanging their currencies into the anchor currencies.

The record of central banks in developing countries was much worse even before the 1970s. During the Bretton Woods period (1946–1971), central banks in developing countries that had signed the Bretton Woods agreement carried out more than 150 devaluations. All but a few developing countries with central banks devalued against their anchor currency—typically the dollar—at least once during the period. And few had currencies that were fully convertible into their anchor currency; instead, they had extensive restrictions or outright prohibitions on exchanging their currency into any foreign currency.

Exchange-Rate Systems and Inflation

Developing countries have done much worse by having central banks than they would have done by continuing their previ-

ous monetary systems or by ceasing to issue their own currencies and using the dollar, sterling, or franc instead. The reasons have to do with the relation between exchange-rate systems and inflation.

There are three types of exchange-rate systems: fixed, pegged, and floating. In theory a developing country could have a high-quality currency under any of these systems, but in practice a fixed exchange rate is the only system with a consistent record of doing the job. Free banking, monopoly issue of notes by a commercial bank, the monetary institute system, and the currency board system were all systems of fixed exchange rates.

People often confuse fixed and pegged exchange rates. They are quite different, however, and have quite different effects. Both are maintained constant in terms of an anchor currency (which can be gold), but the similarity ends there. A pegged exchange rate is maintained constant for the time being in terms of the anchor currency, but carries no credible long-term guarantee of remaining at its current rate. A fixed exchange rate is preferably established by law as permanent, or at most is alterable only in emergencies. A rough-and-ready classification is that a truly fixed exchange rate is altered no more than once every thirty years. (Thirty years is the longest period for which there are active bond and mortgage markets in many countries.) If the exchange rate is altered more than every thirty years it should be considered pegged.

Many people think the Bretton Woods system was one of fixed exchange rates. It was not; rather, it was a mixture of fixed and pegged rates. Few currencies in the Bretton Woods system floated: in 1970 the only ones were the Canadian dollar, South Korean won, and Lebanese pound. As I mentioned, most central banks in developing countries that had signed the Bretton Woods agreement devalued at least once during the Bretton Woods period. The record of central banks in developing countries was no better: most of them devalued at least twice during the period. In contrast, few of the pre-central banking systems (and no cur-

rency board systems) devalued during the Bretton Woods period.

Since the Bretton Woods system ended the pattern has continued. The collapse of the Bretton Woods system continued the weakening of barriers to inflation that began when developing countries established central banks. Of the more than 150 developing countries with central banks, the currencies of all but a dozen have depreciated against the dollar since 1970. Some of the depreciations have been huge: a Russian ruble is today worth about 1/4,000 its 1970 value in dollars, and the Brazilian currency, adjusted for all the zeros that have been chopped off it over the years, is worth less than one-billionth its 1970 value.

Central banks have performed so poorly in developing countries because pegged and floating exchange rates alike do not furnish enough of a barrier against political pressures for inflation. Pegged exchange rates have not worked well in developed countries or developing countries. They invite currency speculators to profit from a devaluation that is almost certain to occur eventually. The Bretton Woods system collapsed because the U.S. dollar was pegged rather than fixed to gold. The largest attempt to peg exchange rates since the Bretton Woods system is the Exchange Rate Mechanism of the European Monetary System, which links several West European currencies to the German mark. It has experienced great difficulties leading to successful speculative attacks on most of its currencies on several occasions, most recently in 1992 and 1993. Among developing countries, the devaluations of the CFA franc (the currency of 13 former French African colonies) and the Mexican peso in 1994 are recent examples of the difficulty of maintaining pegged exchange rates.

Floating exchange rates have a better record in developed countries. After the painful inflationary experience of the 1970s, developed countries found ways to keep inflation to levels not much higher than during the Bretton Woods period. Control of inflation in developed countries has been erratic, but it has been superb compared to

developing countries. However, few developing countries have succeeded for long periods in combining low inflation and floating exchange rates. For example, the severe inflations that have occurred in many former Communist countries since 1989 have occurred mainly in floating exchange-rate systems.

All this experience suggests that the only way for most developing countries to have low inflation is to forget about pegged or floating exchange rates and to have a truly fixed exchange rate with a relatively stable anchor currency issued by a developed country, such as the dollar. And the only way to have a truly fixed exchange rate is to abolish central banks in developing countries and return to one or another of the pre-central banking systems.

The Ebb of Central Banking?

In the 1950s and 1960s a powerful combination of misplaced nationalism and interventionist economics convinced most developing countries that to assert their sovereignty and to fine-tune the economy they needed to replace their monetary institutes or currency boards with central banks. All but a handful of developing countries established central banks.

Recently the tide has begun to turn. On the heels of an inflation exceeding 2,000 percent a year, Argentina stabilized its currency by means of a currency board-like system in April 1991. Estonia, which had suffered inflation exceeding 1,000 percent a year under the Soviet ruble, issued a new currency by means of a currency board-like system in June 1992. And after breaking free of the Soviet Union, experimenting with central banking, and suffering inflation exceeding 1,000 percent a year in 1992, Lithuania established a currency board-like system in April 1994. Argentina and Lithuania use the dollar as their anchor currency, while Estonia uses the German mark.

Like orthodox currency board systems, the Argentine, Estonian, and Lithuanian systems have 100 percent foreign reserves. Unlike orthodox currency board systems,

though, they have had some restrictions on convertibility (now weak or removed) and the fixity of the exchange rate is not entirely secure because the monetary authorities are not well insulated from political pressure. Even so, since establishing currency board-like systems all three have had much lower inflation and have reversed the economic decline they were previously suffering. Their experience contrasts with the experience of other countries in their regions that have retained central banking. Estonia and Lithuania are enjoying economic growth while Russia, Ukraine, and most other former Soviet republics continue to have economic decline and inflation of hundreds of percent a year. Argentina has had four consecutive years of economic growth and has reduced inflation to mid-single digits, which is highly unusual for Latin America.

Other countries in Latin America and the former Soviet Union are now considering establishing currency boards or currency board-like systems. Monetary institutes are not experiencing a similar revival because their principles are not as simple and understandable as those of currency boards. Free banking has received attention from a growing number of economists, but has not yet convinced a broader political constituency.

Developing countries established central banks with high hopes that have been unfulfilled. The best thing they can do to reverse their poor monetary and economic performance of recent years is to abolish their discretionary central banks and fix their currencies to foreign currencies with relatively good records of low inflation. The currency board system is a well understood and eminently practical way of doing so. Other alternatives to central banking are also worth considering. The important thing is to minimize, and preferably eliminate, discretionary government control in monetary policy. □

1. Statistics of inflation and economic growth cited in the next few paragraphs are from World Bank, *World Development Report*, 1982, pp. 110–11, and 1994, pp. 162–63. Within groups, statistics are weighted by gross national product (GNP), so countries with large GNPs affect the group statistics more than countries with small GNPs.



Comparable Worth or Incomparably Worthless?

Panned a decade ago as “the looniest idea since Looney Tunes” and left to die as an idea whose time ran out before it got off the ground, “comparable worth” is making headlines again. It was raised several times in last fall’s elections by candidates who argued that it was a “fair” and “compassionate” thing for governments to adopt.

Comparable worth—known also as pay equity—is not to be confused with “equal pay for equal work,” which free markets tend to promote if there’s good reason to—namely, when all relevant factors in wage determination are identical across different labor markets. Besides, equal pay for equal work, for better or worse, is also the law of the land. Equal pay for *comparable* work is an entirely different animal.

Equal pay for equal work requires, for instance, that a woman be paid the same as a man, or another woman, who is doing exactly the same job. Comparable worth, by contrast, focuses on paying *an entire profession or occupation* the same wage as another, very different, profession or occupation determined by some outside authority to be of the same “worth” or value to an employer.

The idea is that individual workers who perform jobs of substantially comparable value to their employer should be paid similar wages. If the work done by an

accountant is deemed to be as valuable to an employer as that done by a typist, for example, the law would require the two employees to earn the same wage. In Minnesota, firefighters in the city of St. Paul were ranked as having the comparable worth of the city’s librarians.

When many people seek employment in an occupation for which there is declining demand, the tendency in free markets is for wages to fall, sending a signal that people should look for a different line of work. Likewise, wages rise during a labor shortage, sending a signal that more people are needed.

A comparable worth scheme imposed on private sector employers would arbitrarily and effectively abolish the role of supply and demand in the labor market. Conditions in the market wouldn’t matter, because some authority’s “calculation” of the value of one job compared to another would take their place by force of law.

Employers and employees can always produce “experts” who will rank jobs differently than any arbitrary formula, which is why imposing comparable worth would produce a playground for lawyers and a bottomless pit of costly litigation. It rests on the dubious notion that the relative worth of different jobs can be mystically divined and distilled into a cookbook recipe by “experts” who aren’t even in the kitchen.

Advocates usually tout comparable worth as a tool to end discrimination against women in the workplace. They see wages in

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female-dominated occupations lower than wages in male-dominated occupations and assume that the disparity is entirely caused by discrimination. However, many rational factors explain the disparity.

Men, for instance, do not leave their jobs to have children and are less likely than women to leave their jobs to care for children. Men are less likely to move if their spouses must relocate for professional reasons. Men are usually physically stronger than women and tend to work in jobs that have a higher probability of physical harm. (Men, in fact, account for 94 percent of the occupational fatalities each year.) Differentials between the pay of men and women exist because women entering the work force generally have less education and fewer skills and are higher risks for employers than their male counterparts.

The National Committee on Pay Equity claims that women earn only 71 cents for every dollar men earn. Not only does that often-quoted figure ignore the factors cited above, it doesn't even take into account the number of hours or weeks that workers put in. Women, for many reasons, work fewer hours a week and fewer weeks a year than men do.

If employers were guilty of wage discrimination against women for no reason other than stupidity or the desire to be nasty to the opposite sex, then studies would show that female employers pay their female employees more than male employers pay *their* female employees for equally productive work. There are thousands of women who own and manage businesses and to my knowledge, they pay market wages just like their male counterparts do.

What happens when an employer decides to pay a worker less than the market wage? That worker soon leaves, gets hired away, or goes into the business himself (or herself).

High turnover boosts the employer's training and transition costs, which can quickly make that "cheap" employee a very expensive one. In free markets, the employer must heed the signals of supply and demand or see the competition benefit from his shortsightedness. These days, labor is highly mobile and information travels faster than ever before, so markets work better and quicker to bring about fairness and efficiency than their critics are willing to admit.

Some comparable worth advocates unwilling to overturn supply and demand in the *private* sector have focused instead on putting it in place in the *public* sector. In 1984, Minnesota became the first (and so far, the only) state to mandate that all local units of government devise and implement comparable worth schemes. St. Paul is a city whose experience with the law typifies that of local government across the state: \$32 million in additional salary expense between 1985 and 1992, endless disputes about who is comparable to whom, and lingering uncertainty if the city is even in compliance with the law at all.

In his authoritative 1993 book, *Incomparable Worth*, University of Virginia economist Steven E. Rhoads showed that after depressing the wages of computer specialists and nurses in order to achieve "pay equity," Minnesota localities can't find people willing to take those jobs. Women, according to Rhoads' findings, are not clear winners when labor markets are distorted and wages are set by politics and politicians.

The last thing this country or any of its states need is another expensive mandate that substitutes the judgment of bureaucrats for that of the marketplace. Comparable worth—a silly and artificial invasion of free association between participants in the labor market—is incomparably worthless. □

The Prejudice Against Midnight Dishwashing

by Ralph R. Reiland

Child Labor Regulation No. 3 mandates that 14- and 15-year-old kids can't work more than three hours on school nights. As a restaurant owner I can be fined up to \$10,000 per incident if a 15-year-old works an extra half hour on a busy night.

These same teenagers, however, are permitted to participate on school nights in Midnight Basketball leagues, funded in the 1994 crime bill. Once again the private sector has been double-teamed by prejudice and erroneous economic reasoning.

It's assumed that everyone involved with Midnight Basketball is compassionate and well-meaning, and that a program that keeps kids busy and out of trouble at night is worth millions of tax dollars. But a different assumption applies to a restaurateur who keeps the same 15-year-old busy till midnight cutting vegetables for soup. He's seen as some kind of slave driver—a capitalist robber barron who exploits neighborhood youth for profits.

When my two sons were teenagers, I often thought how fortunate I was that on most Friday and Saturday nights, and plenty of school nights, my kids were here with us in our restaurant grilling shish kabobs and busing tables instead of out driving around. They were never forced to do it, but somehow over the years my sons became as

committed to the restaurant as my wife and I. It was a team effort and on Saturday nights it was as exciting and challenging for them as being on a basketball team. Serving 250 perfectly cooked meals in an atmosphere of hectic fun was our goal.

One morning we got a call at the restaurant from the grandfather of one of our employees. "Jay was riding his bike home from a friend's house last night" he said, "and he was hit by a car." Jay, 15, was a dishwasher on school nights and a busboy on weekends. He had left work at nine o'clock. At eleven he was killed.

I think about the irony of that night when I hear Labor Secretary Robert Reich assail Burger King because some kid worked an extra hour. The reality is that kids can be a lot safer in a restaurant kitchen than they are in the streets.

When it came to funding for Midnight Basketball many politicians understood the importance of keeping kids busy and off the streets. Far better to play ball than be drinking and driving, doing drugs, or getting some tenth-grader pregnant. But there's no three-hour limit on the games and the labor secretary won't be there at 4 a.m. to regulate the coaches or hand out multi-million dollar fines if someone cuts his finger.

Those who get the largest number of kids dribbling till dawn will be invited to the Rose Garden to pick up kudos from the president and a big check from the taxpayers. The

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most successful restaurateur, on the other hand, who creates real jobs for the largest number of kids, is more likely to find himself demonized.

"These kids will be learning sportsmanship," said a Labor Department spokesman when I questioned him about the double standard. "The difference is that you're involved in commerce." Somehow it's not commerce or trade when millions of dollars are extracted from a taxpayer's pocket to buy basketballs and pay coaches and administrators. And because I have a bottom line, there's no White House ceremony when I keep a kid out of trouble by having him do real work—learning how to clean, cook, and work with people, seeing the connection between work and reward, earning tuition money, helping his mother pay the rent, building self-confidence by earning income.

"The myth of the Triumphant Individual may have outlasted its time," proclaims Secretary of Labor Reich. "To the extent that we continue to celebrate the traditional myth of the entrepreneurial hero, we will slow the progress of change essential to our economic success. . . . We must begin to celebrate collective entrepreneurship." Mr. Reich is fond of hyperbole, condemning the private sector, indulging in wild accusations about companies "who sacrifice workers on the altar of profits."

Since the health-care debate, I've developed a sensitivity about public officials who tour the land condemning business owners. "These are greedy people who have no

social conscience," said California Congressman Pete Stark. "These people don't care about their employees," said Senator Edward Kennedy. And it was, of course, the first time a First Lady has taken to the road to insult business owners as "freeloaders" if they weren't paying for health insurance for every worker.

The assumption is that we are to be mistrusted and stereotyped as greedy profiteers. Midnight Basketball is smart and moral, while midnight dishwashing is exploitative and illegal. It's an ideology that has delivered billions of tax dollars to failed public sector programs and excessive fines, confiscatory tort law, and regulations to the business sector.

When Secretary Reich dismisses the "entrepreneurial hero," as he so cynically puts it, as a "myth," he ignores the reality that small businesses create the bulk of the jobs—and the virtues that go with these jobs—in this economy. Collectively the Fortune 500 provide fewer jobs than they did ten years ago. One can only speculate as to why Reich has such a distaste for triumphant individuals.

The labor secretary has deliberately missed the key economic and political lesson of our time. In every part of the world, the arrogant and counterproductive policies of overblown governments have flunked the test. Does anyone in the Labor Department ever wonder why the thousands of Cubans fleeing "collective entrepreneurship" never see anyone paddling in the opposite direction? □

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First-Class Mail, Third-Class Competition

by Robert A. Collinge and Ronald M. Ayers

Picture a storefront in a strip mall. “Letter Express” declares the façade. On display in the window is the sign: “Why pay 32 cents and worry if it gets there on time? Guaranteed letter delivery anywhere in the country within two days for \$3.” You have a letter to mail. Not an urgent letter, but you’d just as soon have it get there sooner rather than later. You enter the store and hand over your letter and \$3.

“You’re under arrest! You have the right to remain silent. You have the right to an attorney. . . .” Yes, you have broken the law, by stumbling into a “sting” operation by the United States Postal Service. You have stolen 32 cents from the Postal Service, and will be forced to hand it over, along with a fine.

Okay, we exaggerate. In reality, the U.S. Postal Service (USPS) does not run sting operations, and has yet to seek significant punitive damages from letter senders. Still, it could. Indeed, the Postal Service does seek damages from businesses that employ overnight mails for non-urgent billings or the like. For each such letter mailed via FedEx or another private company, the sender by law must pay first-class postage to the USPS. The USPS intends for that law to be enforced.

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The Natural Monopoly Scam

The post office is an example of a legal monopoly. Why does our government prohibit free choice when it comes to selecting a company to transport mail? Judging from the many firms that survive in the package delivery business, it is likely that competition could thrive for letters as well. Different firms could carve out different niches by offering different combinations of price and service. Of course, some view competition less favorably.

One claim is that postal service is a natural monopoly, so that one firm is able to serve the market more efficiently than could multiple firms. We are told that government restriction is necessary because it would be too costly and confusing to allow more than one company to operate. Without such limitation, the argument goes, there would be a complicated and expensive mess of overlapping routes, along with a proliferation of mailboxes to serve each of the various carriers. Supporters of government regulation worry that customers would wind up footing the bill for such inefficiencies. They are wrong.

If the post office were in fact a natural monopoly, competition would reward firms for getting larger and larger, until only one survived. Unlike the current bureaucratic arrangement, the surviving firm would obtain that status by offering the most valuable

combination of service and price. Costs would be competed to as low a level as possible.

Again, if for the sake of argument, we accept for the moment the notion that the post office is a natural monopoly, we must acknowledge that there is a great deal of potential competition from package delivery services, couriers, telephone services, and fax. Such competitors "lurking in the wings" would motivate the purported natural monopolist to keep prices low and quality high. No regulation would be necessary or even desirable. Thus, one justification for government's legal guardianship over the post office is demonstrated to be false. Is there another rationale?

Politics

The justification is political. Surveys routinely show that, at a personal level, the American public holds postal workers in higher esteem than nearly any other category of worker. Perhaps this is because millions of Americans look forward to receiving the mail each day. Whatever the reason, there is widespread support for mail carriers. So, when postal employees throughout the country argue to maintain the status quo, is it any wonder that most Americans support them?

Postal employees themselves have every reason to support the status quo. Mail carriers are among the most highly paid unskilled labor in the country, with annual salaries averaging nearly \$30,000. Including fringe benefits, 1991 compensation for USPS employees averaged nearly \$45,000.¹ Salaries are much higher than necessary to attract qualified applicants, as thousands of unsuccessful postal job seekers can attest. With popular postal employees throughout the country supporting the status quo, and with a powerful lobbying effort by the postal workers' union, it is no wonder that Congress is reluctant to open the doors to competition.

There is no strong lobby on the other side. While there are an increasing number of complaints about slower and less reliable

service than in the past, the general attitude among the public is "if it ain't broke, don't fix it." The post office seems to work adequately, and is cheaper and more reliable than state postal systems found in other countries. Closer analysis reveals that those other countries also take the government monopoly route, and often have less well-developed markets and infrastructures to keep costs down. However, studying postal services is not a priority in customers' lives, so they pay little attention to the details.

Voters in rural areas also have a compelling interest in maintaining the status quo. Rural residents can send and receive mail daily at the same rates paid by urban dwellers. Since the cost to the post office is much higher in sparsely populated areas, rural mail is implicitly subsidized by urban mail. A government could maintain these subsidies if postal services were to become competitive. In that case, though, the subsidies would need to be explicit. The costs of subsidizing rural pick-up and delivery would then be a visible expense in the federal budget.

Congress shows little interest in debating whether all Americans should have a right to uniform postal service at uniform cost. Yet such a debate could be expected if the expense of subsidizing rural routes is no longer hidden within common postal rates. The higher the profile of the subsidies, the more likely they are to be cut. Urban residents are likely to balk when they see the monetary cost of subsidizing rural lifestyles, especially when all rural residents are there out of choice. For their part, rural residents can best protect their subsidies by keeping the issue out of the spotlight.

Honesty and Good Policy

There are many good reasons to allow competition in the market for first-class mail, and no good reason for the government to be one of the competitors. Competition keeps costs down, and matches services to what customers are willing to pay for. In contrast, restricting competition stifles innovation. Is it worth fining users of alterna-

tive services in order to force them to use what they obviously view as inferior service from the United States Postal Service? How far does this go—do we seek to eliminate the substitution of faxes for letters? Do we fine fax users? Do we fine users of the Internet?

Honesty requires us to address the question of rural subsidization explicitly. Likewise, if postal employees have some special status that merits above-market pay, then government could subsidize their wages explicitly. Such an elite status would prove hard to justify. Neither questions of rural subsidization nor high postal pay are valid reasons to prohibit postal competition. If economically and ethically valid reasons do exist, no one has yet stated them.

The essence of competition is privately owned firms facing off against each other in

order to provide the best value to the customer. When the USPS does battle with private firms, a portion of the tax dollars paid by those private firms is spent to hamper their ability to compete against the government monolith, the USPS. That's not efficient, and that's not fair. Ultimately, policy that is open and honest must allow enterprise the unhampered freedom to compete. Not only should government allow competition, but it should sell off its Postal Service assets, and exit the business. A level playing field in business enterprise does not allow the government to be one of the competitors! □

1. U.S. Department of Commerce, *Statistical Abstract of the United States, 1993* (Washington, D.C.: U.S. Government Printing Office).

Freedom, Legislation, and Disabilities

by James Rolph Edwards

The Americans with Disabilities Act, which took effect in January 1992, attempts to prevent discrimination in employment against the disabled and to guarantee access to "public" (i.e., business) accommodations. Providing "access" to disabled employees quickly began to generate costly adjustments in physical facilities by businesses all over the nation. Within little more than a year, over 9,000 legal complaints had been issued under provisions of the law by individuals who felt that they had been

discriminated against or denied physical access to places of business.

Most members of the academic and intellectual class have welcomed the ADA as a landmark piece of legislation. Complaints by businesses about the costliness of the Act have been dismissed as self-serving. Warnings by economists, based on more systematic data and estimates, have simply been ignored, washed away in a pious river of emotional arguments. The lack of wheelchair ramps, we are told, indicates that "society cares nothing for the disabled"; for the sake of equality we must provide access for the disabled, "whatever the cost."

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The emotive, anti-business argument used to justify the ADA completely mischaracterizes the treatment of the disabled by producers and employers in the market economy. True, not every factory, office, or store has wheelchair ramps, nor have businesses adjusted their physical facilities to accommodate all of the special needs of people with various disabilities. Forcing employers to readjust their facilities every time a person with a different disability is hired, would wreak financial havoc if tried. As a matter of simple economics, physical facilities are best designed around the function of ordinary people. Other customers and clients must make personal adjustments.

But this does not mean that businessmen are indifferent to the needs of the disabled. Such modern innovations as wheelchairs, prosthetics, hearing aids, and eyeglasses are supplied by business entrepreneurs to meet the specific set of needs of a specific set of market demanders. Such products narrow the effective differences between individuals with disabilities and other persons, giving the disabled more access to society and social institutions, and in particular, making the disabled more employable. Industries making such products themselves generate additional employment and add to aggregate real output and income.

Few of these good works resulted from any specific altruistic impulse. Instead, the businessmen who provide such products do so out of self-interested desire for profits. But the genius of the competitive market system, as Adam Smith pointed out, is that it motivates people seeking their own self-interest (as most of us do most of the time) to learn about and supply the needs and desires of others. In the resulting voluntary market transactions, both parties gain by

obtaining something they want more than what they traded to the other in exchange.

Consider, in contrast, the effects of the ADA. While it certainly makes some disabled persons better off, it reduces the net earnings of employers who must, under threat of coercion, make costly adjustments to accommodate the disabled. In addition, reduced earnings of firms throughout the nation mean that aggregate employment must fall relative to its prior level or growth trend. Reduced aggregate employment means reduced aggregate real output and income. Indeed, we may already have experienced this decline.

Perhaps worst of all, discrimination against the disabled may even be increased, rather than reduced, contrary to the intent and despite the penalties of the act. This result follows because the ADA, in contrast to the voluntary market provision of products aimed at reducing disability impairment, increases the disadvantage of disabled persons relative to others being considered for employment, by adding to the costs incurred by firms employing a disabled person.

Suppose you were a business executive considering two applicants of equal skill for a position that pays \$25,000 annually. One of the applicants has a disability. Hiring him would cost your firm an additional \$10,000 in legally mandated adjustments to the workplace. Which applicant would you hire?

It seems likely that disabled applicants will often either not be hired, or hired only at salaries low enough to offset the prospective additional costs they generate for the firm.

The ADA is a perfect example of the harmful character of coercive morality legislation that harms society at large without even benefiting, on net, those it seeks to help. ☐

Fortunately, It's Just a Game

by Candace Allen

I haven't played Monopoly for years and years. But a few nights ago I was given another chance. After I'd banned the television for the evening, my twelve-year-old son persuaded me to play the game with him. It was not the same as I'd so nostalgically remembered. After being soundly beaten, I found myself reflecting on Monopoly's negative and misleading economic messages.

Had I won the game that evening, I may not have made any connections between the assumptions inherent in Monopoly and my previously held attitudes that wealthy people were usually greedy money mongers. But my son beat me, and this caused me to do some thinking. He owned four houses each on the yellow spots (Atlantic and Ventnor Avenues and Marvin Gardens), hotels on Boardwalk, Park Place, and the three magenta spots (St. Charles Place, Virginia, and States Avenues). Though I owned three railroads, the two utilities, three houses on the red spots (Kentucky, Indiana, and Illinois Avenues), and hotels on the light blue spots (the cheap part of town), I could not long compete with him in the win-lose game. When the game was over my son added up his assets and gloated that he was richer and more powerful than I. I felt slightly irritated that he had taken me to the cleaners by owning so much! His kiss goodnight included a pleasant, "Thanks, Mom, for losing all of your hard-earned

money and property to me!" No doubt the real meaning for him was in the time he and I had spent together, but I can't help considering the subtle effects that Monopoly may have on his views about the world of wealth and wealth creation, as well as the effects playing it had on me as a child.

According to the Monopoly insert, the game was originated by Charles Darrow in 1934 during the Great Depression. To Mr. Darrow, who was unemployed, and to thousands of others, the game's "exciting promise of fame and fortune" provided amusement and hope. The object of the game is to become the wealthiest player through buying, selling, and primarily renting property. Monopoly remains today the leading proprietary game in the United States and Western world.

Wanting, intuitively, to measure the effects of exposure to the game, I called my parents to ask them what they remembered about playing it. Essentially, they told me that the game let them dream about becoming rich and having more than anybody else. It was about trying to get on top by taking other people's money in the form of rent. Mostly, it was about being lucky enough to become wealthy. Monopoly seemed to them a game of real life, because the rich would take anybody's money if they could. In short, becoming a winner meant that someone else had to lose. I realized that before becoming a student of economics, I, too, held the belief that when the rich get richer it is always at the expense of others.

Just how much of this attitude may have

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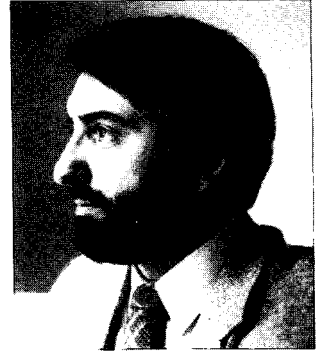
come from playing Monopoly is anyone's guess, but it may be worth identifying the implicit assumptions in Monopoly which could foster erroneous beliefs about wealth creation. One inherent assumption is that luck is the main factor in building a fortune. Luck directs a player to the more lucrative places on the board and only luck can land a sucker on another player's property with a grand hotel. No choices about where to stay and what to pay! Market competition and choice do not temper the rise or fall of the rich, nor does the productivity of the players enter as a factor.

Another assumption is that the acquisition of more and more assets will benefit only the greedy property owner. Successful buying and building in the game never creates new opportunity and new wealth for anyone other than the property owner. At no time does a wave of the invisible hand channel self-interest into the service of others. Rather, more dollars of profit reduce other players' wages each and every time their tokens land on an owned and developed piece of property. The wealth-creation process is equal to the poverty-creation process in Monopoly. Probably the major problem in the game is that the little economy is made up of only two groups of people: those trying to become real estate owners who can develop their property and those who unluckily must land on the property and pay the high rents set on the cards. Nowhere can a customer be found!

Now the purpose of this essay is not to propose a ban on the playing of Monopoly. But surely it is worthwhile to consider its subtle influence on players' attitudes—an influence that may undermine potential understanding and appreciation of the market's ability to generate new wealth. Unless one's children play Monopoly with awareness of the game's limited and untrue assumptions, they may take on negative biases against the allocative functioning of the

market. They may, in fact, come to believe that governmental mechanisms that protect the poor from the wealthy should take priority over the Constitutional protection of property rights, including the implied right of transfer of one's property to others by voluntary and mutual agreement. The productive effort of hard work is essential to wealth creation—certainly not the same activity as merely “passing GO and collecting \$200.” But that understanding is not enough. Children need to realize that productive resource allocation is critical in income generation. And how are resources best allocated? By allowing folks the freedom to trade and enter into contract with one another, not by forcing victims of chance to buy products (or pay rent) that they don't choose to buy.

Though this year's Christmas list won't include Monopoly games for any of the other children I know, I don't think I could convince my son to give it up. Until a wiser game-maker develops a game that can parallel the emotional appeal of Monopoly, I will make it a point to play with him again, and each time I do, I will include questions which will allow dialogue about real world economics. Such conversation may include reasons why developed property is profitable (investment) and what it means when “the bank pays dividends” (interest). It might also be fun to pose hypothetical situations such as, “What would happen if a property tax were imposed on all improvements?” and “What would happen if an income tax were placed on all unearned income?” and “What would happen if all prices rose by five percent and were expected to rise again soon?” In this way my son would learn valuable lessons not only about wealth creation, but about the effects of government policies and inflation upon incentive structures, which influence all players' behavior—in Monopoly, of course, but also in real life. □



Values or Virtues?

As a young man, I wondered why the principles of freedom had failed to win more adherents. Despite the best efforts of freedom's proponents—and after decades of philosophical refinement and practical demonstration—most people remained unswayed.

I became convinced that the public was both apathetic and unprincipled, concerned solely with indulging their most venal, narrow, and immediate interests. Most people, I figured, couldn't care less about matters of moral principle—of distinctions between earned and unearned, just and unjust, "mine" and "yours." I concluded that they preferred interventionism, because it let them to profit at the expense of others.

I became embittered, less and less motivated to promote the ideas of liberty. My sporadic writings acquired a combative tone that only further alienated readers—and editors. As a result, my writing career seemed headed for a Hobbesian end: solitary, poor, nasty, brutish, and short.

Through it all, I clung to the comforting fantasy that I was being rejected solely due to my commitment to *principle*. In the years since, I've met other proponents of liberty who likewise revel in their own cultural

marginality, as if their very unpopularity and ineffectuality confirmed their status as lone pillars of integrity in a corrupt world.

It's a reassuring self-image . . . but a false one. Abandoning that illusion, in fact, is a precondition to succeeding in persuasion.

My own climb from the depths of cynicism began with the slow realization that most of those whom I'd been condemning were, as individuals, benevolent, productive people of considerable integrity. Yet I still couldn't grasp how such good people could fail to appreciate principled arguments. Somehow, we seemed to be talking past each other.

My epiphany—and the turning point in my professional career—was in grasping the distinction between *virtues* and *values*.

Virtues, such as honesty and justice, are abstract moral principles. Properly understood, they serve as indispensable guides to our actions. However, they aren't ends in themselves. Virtues are only abstract *means* to concrete *ends*. The ends are values: the things in life that we aim to gain or keep.

However, most ordinary people aren't very abstract or theoretical: they're focused on values, not virtues. It's not that they're unprincipled or immoral; they're simply just not very proficient in linking abstract principles to life's concretes. They don't fully grasp the relationship between means and ends, principles and practice.

This also applies to their approach to politics. Most people are rightly concerned with the *values* a social system can bring

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Criminal Justice? The Legal System Versus Individual Responsibility, edited by Mr. Bidinotto and published by FEE, is available at \$29.95 in cloth and \$19.95 in paperback.

them. But if they don't see how certain principles will promote their values, they'll jettison those principles as "impractical."

Individual rights, limited government, and the free market are, after all, complex abstractions. If ordinary people don't understand how they serve the ultimate values of human life and well-being, they'll abandon those principles as unworkable.

In my persuasive efforts, I'd been focusing almost exclusively on promoting the *virtues* of a free society, rather than its *values*. I'd been dwelling on why liberty was a "moral" and "just" framework for social action, while neglecting to emphasize the personal values and benefits ordinary people could derive from living in a free society.

In short, it wasn't their "immorality" that was causing my message to fall on deaf ears; it was my own deafness—to their very real and legitimate value concerns.

Once I realized this, I began to refocus my persuasive efforts with a sensitivity to the public's value priorities. No, I didn't "compromise" my principles or water down my philosophy. But I did become acutely aware of the need to tie *my* principles to *their* values, whenever possible. I also became cognizant of the need to address their high-priority, concrete concerns.

For example, the polls show crime is consistently among the highest worries of the public. Yet though our philosophy of individual rights and individual responsibility has vast implications for this issue, I found virtually nothing in libertarian and free-market literature addressing the problem. Given the typical subject matter in such books and journals, it was as if we were confronting the concerns of inhabitants of some alien planet, rather than the real-world worries of ordinary folks right here.

But I discovered quickly that the public, far from being hostile to our philosophical premises, was warmly receptive to them—if they addressed their own value concerns. My *Reader's Digest* crime articles, for instance, have garnered enormous popular responses. The national reaction to *Criminal Justice?* confirms that popular interest is neither superficial nor unprincipled.

On the contrary, far more than social scientists and "experts," the typical American is passionately interested in restoring truth and justice to our legal system. Indeed, on most issues, I've found his value concerns to be quite rational—hence, fertile grounds for our persuasive efforts. But exactly how do we confront those concerns?

Take the drug issue. The typical free-marketer simply declares his principled commitment to free trade in drugs, and discusses the economics. But this utterly fails to relieve the worries of the typical American parent. "Are you endorsing drugs?" he asks. "What about our kids?"

Those are *rational* value concerns. So why don't we reply as follows:

"Personally, I hate drug abuse. Drug dealers are the scum of the earth, and I want to put them out of business. And as a parent, I want to protect kids. But too many kids are getting seduced into the drug trade as suppliers, all because of the high profits.

"There are two things we should do. First, to protect children, there should be much *higher* criminal penalties for any adult who involves kids with drugs in any way. The second thing we can do is take the profits out of the drug trade. Drug laws unintentionally create higher-than-market profit margins. That entices criminal dealers. Legalizing drugs—for adults only—would end the excessive profits in drug sales. That would take away the drug dealer's fancy cars, jewelry, homes. Making drugs available through legal channels would also get criminals out of the trade, and end street violence by competing gangs."

Such an argument, based on shared *values*, will persuade far more ordinary people than any mere declaration of moral principle.

People aren't stupid or corrupt; they simply aren't very theoretically minded. If we wish to reach them, we have to learn that the doorway to minds and hearts is formed by their deepest values. Appealing to those shared values has brought my messages from obscurity to national attention. The same approach can work for anyone else. □

Have Doctors Forsaken Their Ethics?

by Jeffrey A. Singer

Government health-care reform is like Frankenstein's Monster: dead, it seems, but threatening to arise from the grave, regenerated by countless, often contradictory parts. Like the Monster's creator, our politicians and health-care bureaucrats—eager to create *something*—often give short shrift to ethical considerations. This failing is the focus of my essay.

While medical ethicists disagree on a number of issues, there are certain principles nearly all share. Whether or not we intend to adhere to these principles is the question we must answer.

The Hippocratic Ethic

One conflict that must be resolved is the choice between remaining committed to the "Hippocratic Ethic" or embracing what is called the "Veterinary Ethic." The Hippocratic Ethic holds that a physician's ultimate responsibility is to the patient. Consequently, all advice given regarding therapy is based upon what the physician perceives to be in the patient's best interest. The Veterinary Ethic holds that the physician's ultimate responsibility is to the payer, and that advice is therefore based upon what the physician perceives to be in the payer's best interest. An example of this is when the veterinarian recommends to an owner

that an animal be "put to sleep" rather than undergo costly treatment.

As our health-care system is reformed, we risk abandoning the Hippocratic Ethic in favor of the Veterinary Ethic. If the system pushes more and more of us into a "managed-care" setting, where the physician is under the management of insurance company administrators who ultimately answer to government regulators, the physician will be put in the position of conforming to a method of practice where the interests of the payer are paramount.

Similarly, if our system is changed to a "single-payer" type of health-care system, the physician will be under the management of government bureaucrats, who in turn are influenced by budgetary constraints and pressure from special interest groups. The doctor will be forced to comply with practice guidelines set up by the government. Again, the interests of the payer prevail.

Patient Autonomy

The issue of patient autonomy is also important. A fundamental precept of prevailing medical ethics is that patients who are conscious and mentally competent should have control over their bodies in medical decisions. Put another way, nothing should be done to the patient without the patient's "informed consent."

To this end, medical schools and teaching hospitals have institutional review boards to

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oversee research on patients. These boards insist that researchers develop informed consent documents which explain, in layman's terms, the reason for the research, what the researcher predicts the patient to experience and gain, and what the researcher hopes to learn or accomplish by the experiment. Implicit in this policy is the belief that it is possible to make this information clear and understandable to non-physicians, and that most patients can make a reasonably informed decision about whether to consent, even in the case of a complex and esoteric procedure.

When patients are moved into a situation where their doctor must answer to an overseer, they lose the ability to give "informed consent." The doctor must follow regulatory guidelines when ordering tests or recommending procedures, and can only prescribe medications that are listed in a formulary. Is the patient ever aware of other options that could have been considered, even if they were more expensive?

When a doctor prescribes a drug in the formulary, is the patient aware of other drugs that could have been prescribed, and their relative risks and benefits as well as their relative prices? Is the generic drug always as good as the brand-name drug? Is there a more expensive alternative form of treatment that does not involve the use of drugs and yields quicker results that is not being brought to the patient's attention? These questions apply whether we place the patient in a "managed-care" system or a Canadian-style "single-payer" system.

When people are placed on prioritized waiting lists for surgical or diagnostic procedures, they are not fully informed about the risks being taken with their lives by being forced to wait. The ultimate power for decision-making is in the hands of a health-care bureaucracy that determines how much money will be allocated for each problem, and in some cases, to each health-care facility. People may be given a degree of choice regarding who their doctor will be, but they are allowed to make very few choices about what type of health care they receive. In most cases they are kept com-

pletely in the dark regarding the various options that exist. This is because a third party—government or "managed-care provider"—controls the money.

While it is reasonable and appropriate to consider these ethical issues when determining how we intend to transform the existing health-care system, it is important to realize that the time-honored ethical precepts discussed above are already ignored. Over the past several years, policy-makers and health-care providers have begun to change the way in which health care is delivered with complete disregard for medical ethics. In many cases the individual doctor unconsciously violates his ethical credo on a daily basis. As a clinician in private practice, I make this statement based on firsthand observations.

Medicare and Medicaid

Consider first the 40 percent of Americans who are on either Medicare or Medicaid, single-payer types of health-care delivery arrangements. The patient pays little or nothing out of pocket for health-care expenditures. The government is the payer.

Over the years, in order to control Medicare and Medicaid expenditures, the government has begun to manage the way health care is delivered. One way in which it has done this is by changing the way in which it reimburses hospitals for services. Rather than reimbursing on a fee-for-service basis, it does so on the basis of Diagnosis Related Groups (DRG's). The hospital is reimbursed on a flat rate pegged to the patient's diagnosis, regardless of the severity of the illness or the amount of hospital-based services a particular patient requires.

In order to reduce losses, hospital staff-utilization review committees have resorted to intimidating and pressuring physicians to treat certain problems ordinarily handled in the hospital on an outpatient basis. They are also pressured to discharge patients sooner than they would ordinarily recommend. If doctors are found to be "poor utilizers" of hospital resources from a cost-effectiveness perspective, they often must

go to great lengths to defend their actions before peer review committees or else face sanctions. Most doctors don't have the time or inclination to face such hassles. For this reason, most physicians find themselves taking certain risks with their patient's health that go against their better judgment, rationalizing that they are following the prevailing "standard of care" in making their decisions.

Also in the interest of controlling costs, hospitals have gone to a formulary system for dispensing medicines. A Pharmacy and Therapeutics Committee determines what drugs will be available in that institution. If a doctor wishes to place his patient on a medication, he can select only from the medications in the formulary, a catalog of drugs that the Committee decided should be available to doctors practicing in that hospital. If the doctor wants to prescribe Antibiotic "A" for his patient, but this drug is not in the formulary, he has to select his second-best (or third-best) choice. Otherwise, the doctor has to go through a maze of procedures in order to get special authorization to order Antibiotic "A." (The Pharmacy and Therapeutics Committee determines by consensus vote of its members which drugs to place on the formulary, cost being the overriding concern. This formulary affects all hospitalized patients, not just those on Medicare, since the hospital is trying to recoup its losses from operating under the DRG system.) In most cases, the doctor just decides to "go with the flow" rather than take the time to fight for what he sees as the patient's best interest. Again, he finds solace in the rationalization that a hospital committee has made this practice the "standard of care."

Leaving the hospital setting, doctors are under constant pressure to see patients in their offices for a particular illness at a frequency prescribed by Medicare or Medicaid. If they see these patients more often than Medicare or Medicaid "allows" they are not reimbursed for their service. They must choose between practicing medicine that's not in their patient's best interest, or facing financial loss. Oftentimes they opt to follow the Medicare- or Medicaid-prescribed

guideline, rationalizing that the fact this is prescribed by a government agency makes it the "standard of care."

The same can be said for the ordering of certain diagnostic screening tests. From chest x-rays, to mammograms, from cardiograms to prostate-specific antigen (PSA) tests, the proper frequency and indications for ordering these tests are determined by a government bureaucracy. If doctors don't follow these guidelines, they don't get paid. What's worse is that they run the risk of being excluded from Medicare or Medicaid if they become identified as "problems." In most cases, doctors simply acquiesce.

"Managed Care"

Of the remainder of the population not on Medicare or Medicaid, roughly 90 percent receive employer-provided low-deductible health insurance. Few health-care costs are paid out of pocket by the patient. The insurance company pays most of the bills, and passes the cost on to the employer in the form of premiums. In an effort to hold down rising premiums employers have resorted to placing their employees in "managed-care" plans. Today, if we include Health Maintenance Organizations (HMO's), Preferred Provider Organizations (PPO's), or regular fee-for-service plans that have "utilization review" and "pre-certification," more than 90 percent of the non-Medicare/Medicaid population is in "managed care."

In the managed-care setting the same pressures on the physician exist as in the Medicare/Medicaid single-payer system. The doctor must get authorization from an overseeing entity in order to order tests and diagnostic procedures, perform surgeries, or prescribe medications not in the managed-care company's formulary. The doctor must get permission to place a patient in the hospital. In many cases, the doctor must get permission to refer a patient to a specialist. The criteria used by the oversight entity granting permission are closely linked to the issue of cost. Whenever there exists a diversity of opinion in the medical literature regarding the proper management of a par-

ticular medical problem, it enables the managed-care company to seek refuge behind a credible source in defending its policy medico-legally. The overseeing entity will then tend to only allow the least expensive approach to be authorized. These criteria can be overruled if the doctor is willing to jump through enough bureaucratic hoops to get special permission. Of course, if he does this too often he becomes too expensive for the insurance company to maintain on contract. It might terminate the doctor. Consequently, most doctors tend to comply.

It should come as no surprise that, according to the National Ambulatory Medical Care Survey, managed-care programs are less likely to authorize expensive diagnostic tests. For MRI and CT Scans the difference is a factor of two to one. As a consequence, patients with diseases such as cancer are likely to have their conditions detected at a later stage, making treatment more difficult.

Studies by Mark Schlesinger and David Mechanic (*Health Affairs Supplement*, 1993) conclude that although managed-care and traditional fee-for-service plans tend to adopt the same method of treatment where normal practice guidelines are well-defined, where norms are vague the prepaid plans provide significantly diminished levels of treatment.

As an adjunct to their own oversight entities, many HMO's use the primary care physician in the capacity of "gatekeeper." Many of the decisions regarding appropriateness of referrals to specialists, or regarding authorization of procedures or tests recommended by these specialists, are placed in their hands. The primary care physician is financially penalized for expenditure outlays by the managed-care program and rewarded for expenditure savings. This again places him in the bind of having to choose between the interests of the patient and possible financial ruin.

New Medical Ethics

In all of the above examples, the physician is implicitly forsaking the Hippocratic

Ethic. He is making decisions based upon what is in the payer's best interests. All of these decisions are being made without the patient having informed consent. The patient is never aware of what other options existed with respect to tests being done, medicines being prescribed, procedures being performed or not performed, or specialists being consulted.

As Merrill Matthews has said, "In effect, medical ethics has succumbed to medical economics, as paternalism is given precedence over autonomy."

A recent well-known victim of the new medical ethics is former Secretary of Defense Les Aspin. He needed additional vaccinations because of the travel requirements of his job. His doctors gave him a vaccine slightly more risky than one which would have cost \$1.55 more. Secretary Aspin was hospitalized in an Intensive Care Unit as a result. Did anyone ask him if he was willing to pay an additional \$1.55 out of pocket to avoid the risk? Was he even aware such an option existed?

When Senator Bob Dole opted for a prostate-specific antigen test (PSA) in 1991, it led to a biopsy that detected early prostate cancer, and then an operation which the Senator believes saved his life. Most managed-care plans don't see much benefit in this blood test and therefore don't routinely provide it. Fortunately, Senator Dole had the opportunity to make his own decision.

This ethical dilemma need not exist. Doctors need not confront the choice between the Hippocratic Ethic and the Veterinary Ethic. If the patient were again the primary payer, there would be no conflict of interest between the patient and the payer.

If the patient had control of the money, the burden would be on the doctor to get "informed consent," and to give advice in accordance with the Hippocratic Ethic. The patient would settle for nothing less.

But as long as politicians in Washington continue to show a blatant disregard for the ethical consequences of their policies, they will not avoid creating a health-care monster with a tragic destiny. □

Rising Health-Care Costs: Who's the Villain?

by Charles Van Eaton

Why is the level of health-care spending what it is? Why does the rate of growth in health-care spending tend to rise faster than spending on other things? Can anything be done to control the rate of growth, if not the level, of health-care costs, short of having government take control of what now constitutes almost 14 percent of our entire Gross Domestic Product? What can be done to decrease the number of persons who are without some form of private health-care insurance?

As the political debate about health-care unfolded, it became clear that virtually no one in the federal establishment thought that trying to get answers to these questions made any difference in what the politicians were trying to do to move government even more heavily into the health-care-services production system than it is now.

It does make a difference. There are strong differences of opinion on why the level of U.S. health-care costs are what they are, why these costs have been rising faster than the cost of other goods and services, and what government can do both to reduce the level of costs and to arrest the rate of cost growth.

On one side is the view that if the level of spending on health care is the product of

forces over which government can, at best, have little control, there is no reason to give government more control. However, if part of the reason health-care spending tends to rise faster than other streams of spending is the product of policies generated by government programs, and if the goal is to reduce this rate of spending growth, the obvious place to start would be to do away with those government policies which contribute to spending growth.

Those who believe that both the level and rate of growth in health-care spending are problems unique to the private-sector character of the American health-care-services production system see no solution which does not involve granting considerably more power to government.

Why are costs what they are and why do they tend to rise as fast as they do?

“Villain Theories”

On one side of the debate one hears what may be called “villain theories” of health-care costs. These theories focus on the production side of services and conclude that both the level and rate of growth in costs are the product of greed on the part of insurers, pharmaceutical companies, hospitals, and physicians.¹ Until these parts of the health-care-services production and financing system are brought under control, this argument goes, nothing can be done to

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reduce health-care spending. Clearly, policies based on this approach must eventually come to rely on command over, and control of both producers and consumers of health-care services.

Against the villain theory of health-care costs lies the view that the level of health-care costs is a product of six factors, none of which involves villains of any stripe.

1. The level of health-care costs relative to Gross Domestic Product is higher in the United States than it is in other countries because the American health-care system has been so successful in treating conditions which, in past times, would have been untreatable.² Consequently, good medicine increases rather than reduces the proportion of people in our population who have illnesses requiring continued treatment.

Dr. Willard Gaylin argues that "There are more people wandering the streets of the cities of the United States with arteriosclerotic heart disease, diabetes, essential hypertension, and other expensive chronic diseases than there are in Iraq, Nigeria, or Colombia. Good medicine keeps sick people alive, thereby increasing the number of sick people in the population; patients who are killed by their diseases are no longer part of the population."³ (Put another way, while the dead are no longer a cost burden to the health-care system, survivors are.)

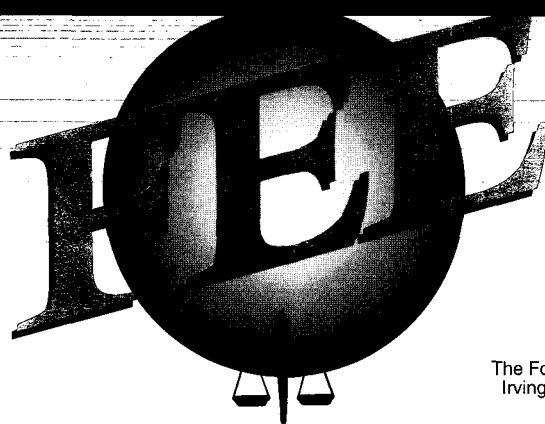
2. The technological superiority of the American health-care-services production system has resulted in an increase in the quantity of health-care services demanded. The technical diagnostic capacity to test for that additional one percent of information, which might provide answers to a medical puzzle, results in a demand for additional testing and additional treatment—at additional cost, of course. (If this reflects a basic American value—wrong in the view of some critics—which says "damn the costs, save lives and use expensive technology whenever necessary," costs are bound to be higher than would otherwise be the case.) Consequently there are many who argue that American medical technology is a major reason for the high level of health-care costs.⁴

3. What is all too often overlooked when

the level of American health-care spending is unfavorably compared to spending in other nations is that the United States, in many ways that are unfortunate, is not like other nations. Therefore comparing the level of health-care spending in the United States relative to spending in other nations is not particularly useful unless all those distinguishing factors are addressed and statistically held constant before cost comparisons are made.

For example, many Americans lead lifestyles that contribute to strong demand for health-care services. As former Secretary of Health and Human Services Louis W. Sullivan noted, "It cannot be overemphasized that the top ten causes of illness and premature death in our nation are significantly influenced by personal behavior and lifestyle choices."⁵ Comparing data collected in 1977 and 1983, researchers found more obesity, less exercise, more drinking, and less sleep in 1983 than in 1977.⁶ Add to this those other factors which extend beyond health care *per se* while simultaneously imposing greater demands on the system—problems having to do with rates of drug usage, crime, family breakdown, rates of HIV infection, and low-birth-weight babies born to unwed mothers—and it is not surprising that health-care spending is as high as it is.⁷ In addition, the United States has a broad underclass enmeshed in poverty. Because they are often uninsured, low-income people with health problems often enter the medical system through emergency wards—the most costly part to the health-care production system—and often postpone treatment to the point that when treatment is given it is more costly.⁸

4. Despite having a persistent poverty segment, America is a high-income nation. A nation with high income is going to spend more on everything, especially health care, because health care is, to use economists' jargon, highly income elastic. When income levels rise by some given percent, the demand for health care rises proportionately more.⁹ It's both as simple and as complicated as this: a rich nation spends more on health care simply because it is rich.¹⁰



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Budget Deficits

An old English proverb may help us understand the nature of debt: "A small debt makes a man your debtor, a large debt makes him your enemy." When the national debt amounted to just a few million dollars, the federal government was a gracious debtor, a protector of all its subjects, enjoying public trust and admiration. Today, with the federal debt approaching \$5 trillion, it is a public enemy feared and disdained by millions of suffering taxpayers.

The pyramid of debt is growing at an annual rate of some \$300 billion and is expected to accelerate in the future. Both the White House and the U.S. Congress are unwilling and incapable of balancing the federal budget. In a sense of desperation about the growing alienation between the people and their government, many Americans favor a constitutional amendment which would require that "total outlays for any fiscal year do not exceed total receipts for that year."

No matter what we may think of such an amendment, the deficits, whether they are on or off budget, are too big to be ignored or taken lightly. They are felt not only in every home and business but also in the money and capital markets of the world. After all, the U.S. economy is a substantial part of the world economy, and the U.S. dollar the paramount world currency.

Budget deficits of the present magnitude are a prominent cause of all that ails

the American economy: declining private investments, stagnant or even falling standards of living, unemployment of millions of workers, and inability to compete in many world markets. It is a fundamental economic principle that economic productivity, income, and wealth primarily depend on the instruments of production in use, that is, on the amount of capital invested per worker. When government deficits consume the capital coming to market, they impede progress and bring stagnation. The trillion-dollar deficits of the federal government have curbed American productivity, obstructed production, and brought on much economic and social evil.

The federal debt is a pyramid of IOUs for income and wealth consumed in the past. It differs fundamentally from business debt which generally is productive and indicative of rising productivity. Government neither forms nor accumulates capital; it merely consumes the savings of its subjects. Even when it spends the funds on public works, it usually wastes them serving lesser needs than they would have served if left in the hands of taxpayers.

Budget deficits are objectionable also on moral grounds. No generation has any right to impose a debt burden on future generations. And yet, our generation did not hesitate to hang a \$20,000 first-mortgage around the neck of every baby born in this country and does not

scruple to increase it by more than \$1,000 every year. As individual debt is the worst measure of poverty, so is political debt placed on our children the greatest outrage.

Yet, it is imperceptive to fault only politicians and bureaucrats for their spending predilection. In an open society, like ours, they are merely the representatives and agents of the public which is condoning or even demanding the deficit spending. In final analysis, we must fault the ideas and morals that guide the people in their political aspirations.

Most Americans live under the spell of progressive economic thought which confers respectability on political profligacy. On all levels of education the "new economics" teaches that government spending sustains, stimulates, and invigorates economic life. Government spending is presented as a benefit without cost, a grand addition to general welfare, a social achievement of the highest order. In reality, it does not sustain, stimulate, nor invigorate an economy; it diverts economic resources to many nonproductive uses and thereby aggravates the situation.

The popular view of government spending as a grand addition to general welfare springs from man's inclination to prefer the seen over the unseen. Government largess is visible to all in many forms, as benefit checks and subsidies, public housing and office buildings, many of which look like Greek temples built to the gods. Few observers see the costs borne by millions of people who are forced to tighten their belts and do without. They must forgo better housing, warmer clothing, comfortable transportation, better education, medical insurance, etc., etc. To a thoughtful person, the marble temples of politics, which may last a thousand years, are durable monuments to the supremacy of political power over individual freedom and economic prosperity. They speak of onerous taxation and deficit spending.

Our growing national debt casts a shadow over our future. Profligacy always comes to an end. Unless he changes his ways, the spendthrift falls in disgrace, facing bankruptcy. A national government need not fear bankruptcy in the usual sense, with complete discovery and equitable distribution of its property. No government on earth has the power to hold the U.S. government responsible for its debt, and the U.S. government does not apply and enforce its own laws on itself. But, like bankrupt individuals, it may be hopelessly discredited, as in resources and character. It may pretend to make payment with depreciated dollars or conduct currency and credit reforms which defraud the creditors. It may declare an indefinite moratorium. After all, a vast army of constabulary is ever ready to enforce its laws, no matter how predatory and immoral.

No law or constitutional amendment can break the spending predilection. It will take a radical change of political thought and public morality to reverse the trend. The change will come when, pressed upon by public opinion, the politicians themselves will begin to forgo some of their own largess. It is difficult for legislators who thrive on expensive gratuities, fees, perks, and shady salary increases to cut the entitlements of welfare mothers and children and to reduce federal outlays for the sick and homeless. Any such attempt is bound to run aground the fury of the beneficiaries and the wailing of many politicians who are humorless hypocrites or hypocritical humorists.

Example draws where precept fails. The federal budget could be balanced promptly if the President himself would be made to suffer a salary cut of 50 percent, if the legislators were made to take a cut of 25 percent, and if all entitlements were frozen immediately. Such cuts would signal an honest beginning and allow us to look forward with hope.



The principle of spending money to be paid by posterity, under the name of funding, is but swindling futurity on a large scale.

Thomas Jefferson, 1816.

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Introduction by Hans F. Sennholz

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5. If there are reasons to believe that Americans spend more on health care because, to an important extent, we are what we are, this only explains the level of health care spending, not the annual rate of growth in spending. (The issue of medical malpractice litigation, too, is one that affects the level of health-care costs.) Why have U.S. health-care costs been rising? Is the cost-increase issue one that also requires a "villain" explanation?

What can government do to change these cost factors? Virtually nothing.

The rate of growth in American health-care costs relative to the cost of other things Americans buy, New York University economist William Baumol argues, is due to the relative difficulty of expanding productivity in services production compared to goods production.¹¹ In Baumol's view, there are no villains.

Baumol, long considered one of America's foremost scholars in the field of productivity analysis, argues that "There is no advanced country in which complaints about rates of cost increase are not heard." In fact, "in fourteen of eighteen countries in the years 1960 through 1990, health-care prices rose more rapidly than prices in general. The U.S. rate of increase was exceeded by that in seven countries—Australia, Austria, Canada, the Netherlands, New Zealand, Norway, and Switzerland. The universality and persistence of the problem suggests something which lies deeper than the particular administrative or institutional arrangements adopted in any single country."

Those inclined to see the rise in health-care costs in terms of villains who must be managed by direct government intervention into the health-care-services production system may be failing to grasp the nature of services production relative to goods production. Both data and theory compel serious observers to acknowledge that it is far more difficult to increase productivity in services such as health care, law, welfare programs, mail, police, sanitation, repairs, and the performing arts, compared to manufacturing, because in the latter the continual development of new tools and manage-

ment techniques makes it possible to expand output with fewer units of labor input.

By contrast, services—particularly health-care services—all have a "hand-craft" attribute in their supply process. Consequently, when productivity rates differ across different sectors of an economy, say, manufacturing compared to health care, the money price of health care will rise relative to the money price of outputs in those sectors where productivity gains are real and substantial. Therefore, Baumol concludes, rising health-care costs are "an inevitable and ineradicable part of a developed economy and the attempt to do anything about it may be as foolhardy as it is impossible."¹²

But even when services productivity is relatively stagnant, real services costs can be seen to be falling despite the rise in services' dollar prices because there is in fact no service whose productivity is untouched by technical progress in other sectors. A general rise in productivity led by those sectors where productivity gains are easier to accomplish means, by definition, that it requires ever less labor time to acquire all things. "In an economy in which productivity is growing in almost every sector and declining in none (modern medical technology has certainly improved some aspects of medical-labor productivity, particularly the development of new tools and techniques which make it possible to do surgical procedures on an outpatient basis compared to an inpatient basis), it is a tautology that consumers can have more of every good and service: they simply have to transfer some of the gains from the sectors that are becoming more productive into the sector that's becoming only a little more productive."¹³ Consequently, the rise in the dollar price of health-care services is not evidence of a system in despair, but only of a broad difference in relative productivity rates between services and goods.

But, Baumol rightly notes, "This happy conclusion is just a bit too simplistic. . . . It will not be easy to convince the layperson that, even though the prices of personal services appear to be rising at a phenomenal rate, in fact the costs of these services (in

terms of their labor time equivalent) are really declining because of increases in labor productivity generally."¹⁴

6. While Baumol's argument as to why the dollar cost of health care has risen relative to the cost of other components of GDP is compelling, it is not, as he would be the first to acknowledge, the whole story. The rest of the story deals with the fact that health-care demand may now be the most heavily subsidized component of aggregate demand. Subsidizing demand for the output of a relative-productivity-lagging health-care sector adds an additional source of pressure to increasing health-care costs.¹⁵

For example, even though the German insurance system is bankrupt despite premiums that come to 13 percent of payroll, after paying the tax, Germans "graze themselves to obesity on medical services because the price of care, as perceived by individuals, is essentially zero."¹⁶

A new econometric model developed by Gary and Aldona Robbins of Fiscal Associates, Inc., which looks at how America finances health care, provides insight into why our current system for subsidizing health care distorts demand and adds costs that increase the probability that some people will be priced out of the market for affordable health insurance coverage. The Robbinses note the following:

- Prices matter. People are not price sensitive in the market for health care as they are in the market for other goods and services because some third-party (Medicare or a private insurer) pays most of the cost of health services. For the same reason, health-care providers are less concerned about the costs of the services they supply because someone other than the patient will pay all or the major part of the bill.

- Health spending has been rising because prices paid by patients have been falling. When we are using someone else's money, we pay less attention to costs and thus spend more. Over the period 1960–1990 the share of personal income spent out-of-pocket on health care declined from 4 percent of total consumption expenditures to 3.6 percent. Over the same period the amount

spent from all third-party sources has more than tripled—from 4 percent of consumption on all goods and services in 1960 to 13.3 percent in 1990. Clearly this increase reflects the fact that the demand for health-care services is the most heavily subsidized component of household spending.

- Most Americans are overinsured because of government policies. Through generous tax subsidies to employers, government "pays" up to one-half of the cost of employer-provided health insurance. A corporation that pays, say, 50 percent of its income in federal and state taxes combined would be able to "escape" half the cost of providing such insurance to its employees. Through Medicaid and Medicare, government directly pays medical bills for the poor and elderly.

- Because it is easier to subsidize the demand for health care compared to the supply of health care, increases in demand result mainly in higher prices rather than in more services. On average, each additional dollar spent on health care buys only 43 cents more of real services but adds 57 cents more to prices.

- The main cause of rising health-care spending is government. Direct government spending has increased from 24 percent of all health-care spending in 1960 to 42 percent in 1990. When tax policies are included—which means provisions in the tax code that make employer-provided health insurance tax-free while individuals who purchase their own insurance must do so with after-tax dollars—the government's share of health spending has risen from 34 percent in 1960 to 53 percent in 1990.

- Because of the third-party character of our health-care finance system, most people have no idea how much they are personally contributing to cover the costs. In 1992 national health spending was equal to \$8,821 for every U.S. household, with most of this burden hidden from view.

- Because of third-party insurance and government subsidies, the most costly services are often the cheapest to patients. On average, patients pay only 4.5 cents out of pocket for every dollar spent on hospitals,

but 68 cents out of pocket for every dollar spent on pharmaceuticals. Thus, to patients, hospital therapy appears cheaper than drug therapy while for society as a whole the opposite may be true.

- Because of government policy, many Americans are uninsured. In 1990, through the tax system, government may be said to have "spent" about \$64 billion subsidizing private health insurance by encouraging employer-based health insurance which is deductible for business tax purposes. At the same time, people who purchase their own insurance are penalized. When state mandates require insurers to cover a wide range of "health services" (hair transplants in Minnesota, for example) and larger firms which self-insure are exempted from such mandates, larger firms are exempted from the cost-increasing effects of such mandates while smaller firms and individuals are not. Add the tax deductibility component and small firms and individuals are often priced out of the market.¹⁷

One must conclude that, however unintentionally, our current system of third-party-driven health-care finance has yielded an unusually perverse outcome: while it contributes to higher levels of health cost for the nation as a whole, it sends a signal to individuals which leads them to believe that health-care costs are cheap. Consequently, the direct effect of rising health-care costs are largely hidden from the majority of individual health-care consumers.

In short, if the word "crisis" has any place at all in the debate, it should not be applied to the health-care-services production system, it should be applied to how we finance the demand for health-care services because this system, which is based on having someone other than the health-care consumer pay the bill, robs individuals of a direct stake in health-care cost control.¹⁸

What should government be trying to do? It certainly should not be trying to impose a massive Medicare or Medicaid system on the whole country. Neither should it be moving to bring all Americans under the umbrella of employer-provided health insurance. These two systems, to the extent that

they have contributed to disguising health-care costs to individuals, have been the single most critical factor in forcing health-care costs upward. Government should move the system away from its heavy reliance on third-party payments toward a system based on individual accountability for health-care spending. Is that the direction government will finally take? We shall see. □

1. In *Putting People First*, President Clinton blamed greed for the growth in health-care costs. "What we need," he said, "is leaders willing to take on insurance companies, the drug companies, and the health-care bureaucracies to bring health-care costs down." Princeton economist Dr. Uwe E. Reinhardt, a frequent speaker before The American Medical Association, believes that physicians earn too much relative to the quantity of real health-care services supplied to patients. See, "Why You're Afraid of the Doctor," *The New York Times Book Review*, April 20, 1990; and "Resource Allocation in Health Care: The Allocation of Lifestyles to Providers," *The Millbank Quarterly*, Vol. 65, No. 2, 1987, pp. 153-176.

2. Willard Gaylin, M.D., "Faulty Diagnosis: Why Clinton's Health-Care Plan Won't Cure What Ails Us," *Harper's Magazine*, October, 1993, pp. 57-64.

3. Gaylin, p. 59.

4. This is not a settled question. See, for example, Stuart H. Altman and Stanley S. Wallack, "Is Medical Technology the Culprit Behind Rising Health Care Costs? The Case for and Against," in *Medical Technology: The Culprit Behind Health Care Costs?* (Washington, D.C.: U.S. Department of Health, Education, and Welfare, Public Health Service, 1977), pp. 24-38. Note: while medical technology may be expensive, these advances almost always lead to more cost-effective total care and better quality of life. It is interesting that in no other industry is less technology considered progress.

5. Alf Siewers, "Don't Socialize U.S. Medicine, Sullivan Says," *Chicago Sun-Times*, June 24, 1991.

6. Leonard A. Sagan, *The Health of Nations: True Causes of Sickness and Well-Being* (New York: Basic Books, Inc. 1987).

7. Nicholas Eberstadt, "Why Are So Many Babies Dying?" *The American Enterprise*, September/October 1991, p. 38.

8. Alain C. Enthoven and Richard Kronick, "A Consumer-Choice Health Plan for the 1990s," *New England Journal of Medicine*, 320:29-31, January 5, 1989, p. 30.

9. In cross-section studies of differences in health-care spending among nations, George J. Schieber and Jean-Pierre Poullier found that each 10 percent difference in per-capita Gross Domestic Product is associated with a 14 percent difference in per-capita health-care spending. Schieber and Poullier, "Overview of International Comparisons of Health Care Expenditures," *Health Care Financing Review*, Annual Supplement 1989, p. 72.

10. Studies conducted by A. J. Culyer reveal that the significantly higher income level Americans enjoy accounts for 80 percent of the amount they spend on health care compared to other nations. See A. J. Culyer, "Cost Containment in Europe," *Health Care Financing Review*, Annual Supplement 1989, p. 23.

11. William J. Baumol, "Anatomy of an Illusion. Do Health Care Costs Matter?" *The New Republic*, November 22, 1993, pp. 16-18.

12. *Ibid.*, p. 16.

13. *Ibid.*, p. 18.

14. *Op. cit.*, p. 18.

15. Does the presence of subsidy really increase demand? According to a Brookings Institution study, as reported by David Kelley in *Reason*, January 1994, in 1964 before Medicaid went into effect, the non-poor saw physicians about 20 percent more frequently than the poor. By 1975, the poor were visiting physicians 18 percent more often than the non-poor. In 1963 among those with incomes under \$2,000, there were only half

as many surgical procedures as among those with incomes of \$7,500 or more; by 1970 the rate for low-income people was 40 percent higher than for those with middle-class incomes.

16. Wilfried Prewo, chief executive of the Chamber of Industry and Commerce in Hanover, Germany, "Germany is Not a Model," *Wall Street Journal*, February 1, 1994.

17. Gary Robbins, Aldona Robbins, and John Goodman, "How Our Health Care System Works," *National Center for Policy Analysis Policy Report No. 177*, February 1993.

18. Grace-Marie Arnett, president of Arnett & Co., a

Washington, D.C., health-policy consulting firm, argues that "In virtually all developed countries, the concept of using health insurance as a protection against financial risk has been lost. Instead, health insurance has become a plan for pre-payment of routine medical expenses." See "You Bet Your Life," in *National Review*, May 24, 1993, pp. 30-34. In the same vein, Peter Samuel argues that "While America's medical technology and professional expertise are unmatched, our health-care financing arrangements are collapsing." See "Health Reform Politics," in *National Review*, May 24, 1993, pp. 34-37.

Letters to the Editor

Libertarians and Crime

In his article "The Real Enemy of Liberty" (December 1994), Robert James Bidinotto laments that crime "curiously . . . has gotten scant attention from most proponents of the free market system."

Bidinotto goes on to say that "Free marketeers typically posit government per se as the *enemy* of individual rights and liberty. . . . [And] in their eagerness to denounce *governmental* violations of rights, these same individuals ignore the very evils that governments were established to eradicate: *individual* violations of rights."

If all our taxes were used by government officials for the sole purpose of defending against and punishing internal crime, and defending from attack from enemies outside our country, it is probable that no free market and libertarian organizations would ever have come into existence.

But we are skewered to geometric tax levels to pay for the cost of thousands and thousands of functions that government *should not be involved with*. If the attention of government today were focused on and confined to combat crime, crime would once again become the entire focus of government action, with undivided attention.

Surely Mr. Bidinotto is not suggesting that libertarians opt for *another crime bill to spend billions to be raised by further increases in taxes!*

My greatest fear by far is of those who plunder and enslave me *legally*. I have no personal protection against government plunder, except to enter the overwhelming battle of numbers where it may take forty years to throw the rascals out via the ballot box. That is the fear libertarians are immersed in and talking about.

Hopefully, Mr. Bidinotto, will distinguish the difference and get off the backs of libertarians.

—JOHN C. SPARKS
Canton, Ohio

Robert James Bidinotto replies

I agree that government has diverted resources and attention away from its basic goal—that of

fighting crime—into a vast array of activities that are morally onerous and constitutionally unwarranted.

In fact, that's exactly what I argue in my book, *Criminal Justice?* Welfare state programs "diverted badly needed funds from the criminal justice system. . . . [As a result,] police are underfunded and undermanned to face the ever-mounting crime wave; court dockets are flooded with impossible caseloads; jails and prisons are filled to overflowing." (Pages 66-67) If public spending were redirected toward establishing justice and public safety, we'd certainly need no increase in taxes.

However, I disagree that governmental violations of rights are somehow worse than private violations of rights. To most Americans, *who* victimizes them is far less important than the *fact* of their victimization. They thus find libertarian indifference to the current carnage on our streets bizarre and disproportionate, when contrasted with libertarian obsession with the hypothetical possibility of future dictatorship.

Libertarians must decide whether their defining purpose is a narrow "anti-statism," or if it's a broader defense of individual rights against *any* enemy, public or private. Should they continue to ignore or minimize the valid concerns of ordinary Americans about *private* violations of rights (crimes), their cause will rightly remain socially marginal and culturally impotent.

—ROBERT JAMES BIDINOTTO

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Justice or Legal Extortion?

by Sarah J. McCarthy

Shame on the managers of the Las Vegas Hilton for not recognizing that the elite corps of Navy aviators known as the Tailhook Association needed a babysitter. For that failure, the American legal system has sent yet another in its endless series of messages to private industry. "You are the fall guy," says the message, "and we're here to shake you down."

The guys in the gauntlet may have flown away free as Phantoms, but the Las Vegas Hilton has been found guilty of "inadequate security." In civil court where the standards of responsibility are much looser than in criminal court, Lieutenant Paula Coughlin is expected to be the first of many winners. She has received an undisclosed settlement from the Tailhook Association and was awarded \$1.7 million in actual damages and \$5 million in punitive damages from the Las Vegas Hilton, money that will ultimately be paid by the stockholders, employees, and customers of the Hilton.

Whether it be the \$2.9 million initially awarded to the woman who spilled a cup of McDonald's coffee on herself as she drove along in her grandson's sports car balancing the coffee on her legs, or the judge who later reduced McDonald's fine to a mere \$640,000, it's clear that the U.S. civil justice system has become little more than a spectacular sweepstakes game with an anti-business bias.

A longtime Pittsburgh bridge-painting company, E. Smalis, recently received the

Ms. McCarthy, a Pittsburgh restaurateur, is published in Barron's, Forbes, and The Quotable Woman.

highest penalty ever levied against a single construction company, a \$5 million fine for allegedly exposing their workers to lead. Another Pittsburgh bridge-painting company, Manganas Company, has been fined \$1.3 million by OSHA. "I tried to work with OSHA," explained Mr. Manganas. "I try to comply with their laws, but they won't tell me what to do. They just want to fine me. I've been painting bridges around Pittsburgh since 1946, and I've never had a death on a job. Now I'm afraid they're going to put me out of business. I can't bid on any new jobs while waiting for my court case."

Mr. Manganas believes that OSHA agents dressed in camouflage were hiding in the woods above his jobs to investigate him. Far-fetched? Maybe, but in a climate where business has been increasingly treated as Public Enemy Number One by government agencies, maybe not. "I tell our companies, 'watch out for OSHA,'" says Peter Eide of the U.S. Chamber of Commerce. "They have the power to make life miserable, and they are."

In the restaurant business, we get nervous when Health Department inspectors pay us one of their surprise visits during a busy lunch. Their flashlights scope under every nook and cranny and their thermometers poke into our soup. Our hot foods must be always kept at least at 140 degrees. They write us up if any food is sitting out on the counter, if anything is uncovered, or if anything is in the wrong shelf position, such as raw chicken which must always be on the bottom. Every prepared food item must have the date it was prepared on the con-

tainer. Any cracked tiles or faulty refrigerators will need to be replaced. They make sure our spaghetti sauce is given an ice bath for a faster cool down before being refrigerated.

If a restaurant is functioning at 90 percent, they revisit, monitor, and instruct until a higher level of compliance is reached, holding classes for young chefs and refresher courses to update the knowledge of owners and experienced chefs. There are thousands of rules governing food preparation, and the Health Department's focus is on education and training. Draconian fines and shut-downs are used only as a last resort for uncooperative restaurants. All of us recognize that businesses must conduct themselves scrupulously, but some regulatory agencies are demanding impossible standards and recklessly trying to break businesses. Department of Labor Secretary Robert Reich personally went and closed down the Dayton Tire Company after an accident there. His actions overruled by a judge, Reich was seen by many of the workers there as threatening their jobs through his grandstanding and overreaction.

Government vs. Business

Stereotypes and biases unacceptable towards any other groups are tolerated and encouraged when directed at businesses. The chairman of the EEOC observed at his inaugural press conference last year that businessmen are frightened when they get a call from the IRS or EPA. "By the end of my term," he said, "I hope people worry when they get a call from the EEOC." The same government that endlessly wrings its hands about job creation does its utmost to destroy jobs, especially in the small business sector. "What you have is a government out of control," states Susan Eckler of the Heritage Foundation.

Businesses are being hit with large fines not only for mistakes they have actually made, but for things others have done on their premises, or for the misuse of their products by others. Wendy's International has decided that it's too risky to serve hot

chocolate in America. Will restaurants that serve slushes be liable for frostbite? What if someone pokes his eye out with a plastic straw?

It's time to recognize that our legal system is simply not performing the duties with which it is charged. It is neither protecting Americans from violent crime, nor resolving civil disputes in a fair and unbiased manner. A rapist or murderer is presumed innocent in court, while a small-business owner is not. Courts bend over backwards to assure that correct arrest procedures are used to protect the civil rights of murder suspects, but a businessman is met with a legal system biased in favor of redistributive economics.

If something unsavory like sexual harassment happens at a business, the owner will not be excused from outrageous fines even if she was totally unaware of the event. She will be judged by the "should have known" standard. If anything happens in a business, then the owners "should have known" about it according to the law, even if they have branch offices in different cities. A society that designates spilled coffee and workplace flirtations as financial catastrophes is a society whose citizens live in fear. America's businesses exist in a climate not unlike that experienced by citizens of totalitarian regimes who wait for the knock at the door.

On the criminal side, too, the glitches have become truly bizarre. In a recent *Harper's*, editor Lewis Lapham states, "Maybe we live in a society where a sufficient force of publicity and \$5 million in legal fees buy the privilege of cutting off a woman's head."

The American people are beginning to suspect that these horrors are not glitches at all, but just business-as-usual in the legal system.

Pennsylvania's recent gubernatorial race hinged on the furor surrounding the early release of a murderer by the lieutenant governor when he served on the Pennsylvania Parole Board. The parolee has been since arrested in New York where he's charged with murdering one woman and raping another. The lieutenant governor was

shocked and indignant that anyone might want to hold him accountable for the crimes resulting from his unfortunate decision, but one can be certain that if such mishaps had occurred in the private sector, the punitive damages incurred would have been stratospheric.

Unequal Standards of Justice

If there were an equal standard of justice for the private and public sectors, parole board officials who release murderers would be held financially responsible for inadequate public security. Crime victims' families would be able to take their houses. Their pensions and lifetime earnings would be confiscated to send a message to any other official who might be negligent or soft on crime. Lawyers, too, would be able to be sued for the damages resulting from the escalation of hostilities and hostile environment that often ensues after they interject themselves like bulls in china shops into workplace or marital disputes. Harsh penalties, indeed, but such is the quality of justice meted out every day to America's businesses, large and small. If lawmakers and lawyers were subject to the same standards and onerous penalties that they inflict on businesses, perhaps they would be less likely to impose such fines.

A legal system that is soft on crime and tough on business will produce fewer jobs and more crime. *The Wall Street Journal* targets a Philadelphia judge as one of the worst. Reports the *Journal*, "some 67 percent of all defendants released because of her prison cap simply fail to appear in court. And in the past 18 months alone, 9,732 arrestees out on the streets on pre-trial release because of her prison cap were arrested on second charges, including 79 murders, 90 rapes, 701 burglaries, 959 robberies, 1,113 assaults, 2,215 drug offenses, and 2,748 thefts."

Such mayhem is more dangerous to society than McDonald's coffee, but it's McDonald's who gets hit with jackpot damages because they "should have known" that their coffee was dangerous. The prosecuting attorney said McDonald's had "known

about these injuries for 15 years." The streets of America have been a hostile environment for at least that long, but who in the criminal justice system can citizens sue for inadequate security?

If judges and parole board officials were held to the same unfair and unreasonable "should have known" standard that is used to judge companies, they would be expected to have known that 60 percent of violent offenders on early release are re-arrested within three years for a felony or serious misdemeanor. Does anyone believe that any restaurant operates with a 60 percent coffee scald ratio?

In most areas of public policy, our lawmakers have exempted themselves from the rules and penalties that they apply to the rest of us. Until the 1995 Congress changed the law, Congress exempted itself from the minimum wage law, overtime pay rules, age discrimination laws, The Occupational Safety and Health Act (OSHA), disability laws, The Family and Medical Leave Act, and all civil rights legislation, including the sexual harassment laws. Members of Congress have exempted themselves, too, from the punitive damage fines that are levied with such gusto on the private sector. Even under the new legislation that makes Senators and Representatives on Capitol Hill subject to the same laws that they apply to the rest of us, there's still no real equality between how the private and public sectors are treated. All the new costs for employee overtime or family leave will be shifted to the taxpayers. No Senator will pay a penny from his personal funds, unlike employers in the private sector. Further, under the new legislation that allegedly makes politicians as accountable as the private sector, if any Senator or Representative is found guilty of sexual harassment or discrimination, all fines are shifted to the taxpayers.

Would lawmakers think it fair that they be personally liable for the dangerous and hostile environment they have permitted to exist on the streets of America's cities? Mr. Manganas is proud that no deaths have occurred on his watch. If only our judges and parole board members could say the same. □

Are We Burying Ourselves in Garbage?

by Richard Shedenhelm

One of the foremost difficulties facing American cities is where to put the refuse generated every day. It is widely thought that the United States is literally burying itself in garbage—producing mountains of waste and running out of places to put it.

The alleged crisis has prompted a renewed interest in incineration, source reduction, composting, and recycling. Recycling has been the most popular, and the most costly. Outside of saving natural resources, saving our landfills is the most frequently cited reason for recycling.

If the crisis mentality that shrouds the issue of landfills is found to be largely a matter of political misinformation and factual error, then we will have uncovered a major misdirection of local, state, and federal policy. An objective examination of refuse generation and management is in order.

Are Americans Producing Mountains of Trash?

A popular idea in public discourse today is that the United States produces an overwhelming amount of trash—so much that

our landfills will not be able to handle the quantity. The most eloquent symbol of this viewpoint was the “garbage barge,” which in the late 1980s left Long Island and could not find a port or country willing to accept its 3.168 tons of refuse.¹

The actual data (such as they are) on the amount of municipal solid waste produced present us with more questions than answers. “Municipal solid waste” is defined as “solid waste generated at residences, commercial establishments (e.g., offices, retail shops, restaurants), and institutions (e.g., hospitals and schools).”² The first question concerns the matter that is being quantified. For instance, an EPA report published in 1990 states that during the years 1960 through 1988 American commercial and residential refuse amounted to 156 million tons, i.e., 3.47 pounds per person per day. This statistic for refuse did not include the 13 percent of discards that were recycled.³ Many studies of solid waste generation rates are unclear about their definition of “waste,” e.g., whether automobile bodies, ash from industrial boilers, industrial waste, construction, and demolition debris were included in their analysis.⁴ (According to William Rathje, an archaeologist who has spent over two decades investigating actual landfill contents, construction and demolition debris represents about 12 percent by volume of a typical landfill.)⁵

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Part of the difficulty results from the methodology employed. One popular method of estimating the quantity of solid waste is the "materials-flow" approach. As indicated in *Facing America's Trash*, this technique estimates solid waste generation without any actual measurement at the points of generation (households, offices, stores) or disposal (landfills, incinerators, recycling facilities). Instead, this method makes assumptions about such things as the lifetimes of products, recycling rates, and the effects of imports and exports.⁶ One difficulty of this approach, as Rathje and Murphy observe, is that certain counterfactual assumptions tend to be made about product durability. For instance, one study that used the materials-flow approach simply assumed that major household appliances have a useful life of 20 years, after which time they are thrown away. In fact, appliances such as washing machines and refrigerators last much longer in low-income households and as a source of parts no longer carried by dealers.⁷

A second question regarding the data of solid waste generation is one of temporal perspective. The earlier-cited figure of daily per capita solid waste generation (3.47 pounds per day) covered the period after 1960. Not taken into account is the greater waste per capita generated in previous ages. According to Rathje and Murphy, there were over three million horses living in cities at the turn of the century. Each one produced at least twenty pounds of manure daily. Hundreds of thousands of these horses died each year and had to be disposed of. In addition, over twelve hundred pounds per year of coal ash (for cooking and heating) from each American had to be gotten rid of.⁸

Historian Martin Melos found that between 1900 and 1920 Manhattan residents generated an annual average of 160 pounds of garbage, 1,230 pounds of ashes, and 97 pounds of rubbish.⁹ The total comes to 1,487 pounds, per capita, 17 percent higher than the above-cited 1,267 pounds allegedly produced by each American annually between the years 1960 through 1988.

According to figures from the American Public Works Association and the Environmental Protection Agency, as late as 1939 cities like Newark, New Jersey, and Austin, Texas, reported annual per capita discards of garbage, ash, and rubbish 20 percent greater than the refuse of the average American in 1988.¹⁰ True, affluence may cause more discards (since in one sense affluence *means* there are more things per capita to eventually discard). But along with a higher standard of living come phenomena such as "light-weighting," where the producers of a commodity (e.g., plastic cola bottles and aluminum cans) find a way to produce the same service with less material. As Judd Alexander observes, fast-food restaurants also help decrease waste: a typical McDonald's discards less than two ounces of garbage for each customer served.¹¹

Affluence may also induce *less* waste of food. Rathje and Murphy found that due to packaging, U.S. households produce a third less garbage than households in Mexico City (even after correcting for family size). The main reason for this difference is that a greater percentage of food in Mexico City is bought "fresh" (i.e., unpackaged), resulting in a larger volume of spoilage and more refuse.¹²

The news about waste generation is not all bad. As Clark Wiseman points out, between 1960 and 1970 municipal solid waste grew at an annual rate of 3.2 percent. Between 1970 and 1986, the annual growth rate declined to 1.7 percent (with the amount entering landfills growing by only 1.0 percent). This rate is far less than the growth rate of the consumption of goods and services.¹³

A few cities have actually kept track of the solid waste disposed over certain periods of time. According to Harvey Alter of the U.S. Chamber of Commerce, Los Angeles had an unchanged per capita generation of solid waste disposal (by weight) between 1967 and 1976. He also concludes that for the nation as a whole, municipal solid waste generation was almost constant on a per capita basis.¹⁴

Are Landfills Not Being Built Fast Enough?

The data for landfill openings and closings are similarly ambiguous. To begin with, a modern landfill is not a "dump"—a distinction with more than semantic characteristics. A dump was basically an open pit, but the modern landfill has a system to collect and process leachate and manage the methane gas generated by organic decomposition. It has a clay and plastic lining, and is covered over daily with about six inches of dirt.¹⁵

The modern landfill is a complex system with a lifetime much shorter than its predecessors. The majority of sanitary landfills are designed for approximately ten years of operation.¹⁶ Hence, in any five-year period, half of these close. We are not necessarily in any "landfill shortage" just because in 1989 we could say that "by 1995, . . . half of our nation's landfills will be closed."¹⁷ Like the five-day stock of Cheerios on the store shelf, an *inventory* of landfills is all that is economically necessary, not ready-and-waiting landfills for the next one hundred years.

The question could arise, however, whether landfills are being built fast enough to replace the ones that close down. To begin to address this issue, we should note that the "landfill problem" exists only in certain parts of the United States, and not in the country as a whole. For instance, Wiseman estimated that at the current rate of solid waste generation, the nation's solid waste for the next 500 years could be buried in a single landfill 100 yards deep, 20 miles to a side.¹⁸ In almost every state, there is no physical or environmental constraint on the building of sanitary landfills. In New York state, a study found 200 square miles of land capable of environmentally safe landfills.¹⁹ Less than 10 percent of that area is needed to serve the entire state for the next century.²⁰ If there is an impediment to siting new landfills the cause cannot be physical but instead political. Specifically, the NIMBY (not-in-my-back-yard) problem has kept many jurisdictions from siting new landfills. In addition, some states with lower landfilling costs have tried to ban the importation of other states' refuse.²¹

Despite the "crises" in landfilling for certain areas of the United States (most notably the Northeast and Florida), there is reason for hope. In the long run, environmentally safe, private landfill space may open up to meet areas facing high tipping fees (the per-ton charges at landfills for garbage trucks to leave their load of refuse). For example, Alexander recounts how the tipping fees in the Northeast began to skyrocket in the late 1980s because of a rash of landfill closures by state officials. By the summer of 1992, the tipping fees began to plummet due to the competition of private landfill companies. These companies had responded to the sharp increase in tipping fees by buying the land and permits needed for new landfills.²²

Conclusion

The crisis mentality has distorted judgment of waste disposal. The notion that modern America is especially wasteful is demonstrably wrong, both in terms of the last decades as well as the last 100 years. The idea that our landfills are literally "running out" is even less credible. If in the next century major portions of the United States really need to export their refuse to other states, a "gold mine" for refuse burial does exist: South Dakota. This state is geologically, economically, and politically almost ideal for massive municipal solid waste management: much of the western portion of the state consists of cretaceous shales, much of the land is unsuitable for anything except grazing, and the area is in general sparsely populated (hence unlikely to suffer a lot of NIMBY resistance).²³ Should such an alternative become necessary, the most efficient form of transportation would probably be by rail—which is already one of the cheapest forms of waste transport.²⁴

So, in the matter of a few years, any "shortage" of landfills (as reflected in higher tipping fees) can bring about the opening of new landfill space. Landfill space is an economic resource, and if we consistently regard it as such we can view the present situation as analogous to the oil crisis of the 1970s.²⁵ □

1. William Rathje and Cullen Murphy, *Rubbish!: The Archaeology of Garbage* (New York: Harper Collins, 1992), p. 28.
2. United States Congress, Office of Technology Assessment, *Facing America's Trash: What Next for Municipal Solid Waste* (Washington, D.C.: United States Government Printing Office, 1989), p. 4.
3. Judd H. Alexander, *In Defense of Garbage* (Westport, Conn.: Praeger, 1993), p. 13.
4. *Facing America's Trash*, p. 4, 74.
5. *Rubbish!*, p. 100.
6. *Facing America's Trash*, p. 75.
7. *Rubbish!*, pp. 49, 188–191.
8. *Rubbish!*, p. 50.
9. *In Defense of Garbage*, p. 5.
10. *In Defense of Garbage*, p. 7. One should also take into account the qualitative difference of the waste. The burning of soft coal in the 1930s made a much more objectionable form of waste.
11. *In Defense of Garbage*, p. 54.
12. *Rubbish!*, p. 217.
13. Clarke Wiseman, "Government and Recycling: Are We Promoting Waste?," *Cato Journal* (Fall 1992), 12, p. 446.
14. Lynn Scarlett, *A Consumer's Guide to Environmental Myths and Realities* (Dallas: National Center for Policy Analysis, 1991), p. 8.
15. Kenneth Chilton, "Solid-Waste Policy Should Be Directed by Fundamental Principles. Not Ill-Founded Feelings," *Resources Conservation and Recycling* (January 1993), 8, p. 2. *Facing America's Trash*, p. 281.
16. "Government and Recycling," p. 446.
17. National Solid Wastes Management Association, *Special Report: Landfill Capacity in the Year 2000* (Washington, D.C.: National Solid Wastes Management Association, 1989), p. 1.
18. Clark Wiseman, "Dumping: Less Wasteful than Recycling," *Wall Street Journal* (July 18, 1991), p. A10.
19. *Environmental Myths and Realities*, p. 3.
20. *In Defense of Garbage*, p. 155.
21. "Fundamental Principles," p. 9.
22. *In Defense of Garbage*, pp. 155–156.
23. Jay H. Lehr, "South Dakota Is the Answer, What Is the Question," *Ground Water* (May/June 1991), 29, pp. 322–326.
24. American Public Works Association, *Rail Transport of Solid Wastes* (Chicago: American Public Works Association, 1971).
25. Iraj Zanki, "Solid Waste Management Strategies—A Question of Priorities," *Journal of Resource Management and Technology* (April 1989), 17, p. 59.

THE FREEMAN
IDEAS ON LIBERTY

Eco-Fascism

by Russell Madden

The violations of private property rights that have flowed from the environmental movement and its adherence to the erroneous theory of "intrinsic value" have already caused intense hardships for many people. Individuals have been prevented from developing their land as they best see fit because of claims by environmentalists that such usage would threaten an endangered species, a coastline, a wetland, or the general "character" of some landscape. The contention is that efforts to enjoy the benefits of these properties would destroy the value which that land or animal or plant supposedly possesses by its mere existence regardless of its relationship to specific human beings.

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Unfortunately, as the old saying goes, "You ain't seen nothin' yet."

Generally, owners are allowed to retain title to the property under question but are prohibited from altering it in any way which does not follow some (usually ambiguous and frequently self-contradictory) governmental law or regulation. While they suddenly find themselves denied any say in what to do with that land, these hapless owners are still permitted the privilege of paying taxes on the property in question. This type of titular ownership devoid of control fits the definition of that economic/political system known as fascism.

Given their successes in gaining governmental control over many disparate pieces of private property situated near so-called "ecologically sensitive" areas, the advocates of environmental fascism have gained

confidence and grown bolder. They are now advocating a move that takes the environmental movement from a practice of petty theft to grand larceny on a breathtaking scale. The more radical practitioners of the theory of intrinsic value are no longer satisfied with the passage of laws that prevent the removal of a tree, the building of a fence or house, or the dumping of a few loads of dirt without permission. Their new Holy Grail is to create millions of acres of wilderness zones that will not merely regulate human usage, but will prevent anyone from venturing into such areas for even esthetic enjoyment. It is the intrinsic theory of value taken to its ultimate conclusion: the total elimination of human beings.

The Wildlands Project

The North American Wilderness Recovery (Wildlands) Project suggested by the Earth First! movement and its founder, Dave Foreman, proposes a violation of property rights which is so outrageous that many people might be tempted to dismiss it out of hand.¹ It would be easy to assume from its ludicrous provisions that the Wildlands Project would stand no realistic chance of passage; that defenders of private property could easily ignore it and devote their efforts to other concerns.

Yet fifty years ago, who would have supposed it credible that a snail, an owl, or a tree on one's own land would become excuses for the ecological fascism that has already spread its tentacles not only into American society, but throughout the entire world? The micro-management of land usage we have witnessed in the past thirty years now aspires to "macro-management" of the entire continent.

In these wilderness preserves, all evidence of humanity would be erased. All dwellings, the roads that link them together, the power lines that feed them, and any and all other man-made constructs would be removed and destroyed. Plants and animals—not people—would become the definers of value and usage. The needs, interests, or desires of human beings would be

ruthlessly excised from any "ecological" decisions by the central planners of this ecological fascism. People would become subordinate to lower life forms in a crazy flip-flop of values and priorities. The needs of other species—not the protection of human rights—would become the new basis and rationale for politics if those who accept the credo of Earth First! have their way.

This movement becomes less a wild-eyed pie-in-the-sky and more of a scary potential reality when you realize that otherwise reputable scientists support the general premise if not the specific details of such widespread preservation attempts. John Robinson, a biologist with the Wildlife Conservation Society, believes preservation should be done on a "landscape level." Another biologist from Oregon, Reed Noss, suggests that conservation must be practiced on a scale large enough to include not only endangered animals or plants, but also supporting flora and fauna and entire ecosystems in which natural selection and adaptation can occur.

New Endangered Species: Man

The logical conclusion of such premises is the removal of human beings from the entire earth, the largest ecosystem that exists. Then and only then would "Gaia" be restored to health.

While the eco-fascists have not yet announced such a far-reaching target, according to Michael Soule, creator of the Wilderness Project, they are unconcerned with "the limitations of time and space." They are committed if necessary to a centuries-long endeavor to restore much of North America to its pristine condition before the advent of humans altered these landscapes. Noss would like to see "*at least half* of the land area of the coterminous states" (emphasis added) included in this "hands off" zone. Additionally, these zones would be bordered by buffers in which only limited human activity would be allowed. Eventually, land occupied by people would exist only as isolated pockets within the greater wilderness areas.

Spokesmen for such groups as the Society for Conservation Biology, The Wilderness Society, Defenders of Wildlife, and even members of the U.S. Fish and Wildlife Service offer support for the general idea of the Wilderness Project. Peter Brussard from the University of Nevada at Reno believes that the Project "certainly is justifiable scientifically." Luckily, not all biologists accept that position; Deborah Jensen, a biologist with The Nature Conservancy, does not believe that the goal of conserving biodiversity requires such an approach as the Wilderness Project.

Even if those touting the Wilderness Project do not believe it possible to create such a massive preserve in one fell swoop, they may yet achieve their final goal piecemeal. Efforts are currently underway to set aside 139,000 square miles in the Great Plains for a buffalo sanctuary; the Paseo Pantera project seeks to connect wilderness areas in Central America; British Columbia is linking a new 4,000-square-mile park with Alaska and the Yukon Territory to create a 33,000-square-mile preserve; Congress is considering setting aside 11,000 square miles in California; the Nevada Biodiversity Project seeks to set aside hundreds of square miles of mountains; and Noss recently received \$150,000 from the Pew Charitable Funds to further planning for wildlands set-asides.

In response to this proposal, some people were rightfully outraged.² One woman from Nevada said that, "Proponents of the project are incredibly insensitive to the values, freedoms, and property rights of the many millions of people who live in and love" these lands. She characterized these ecologists as "an arrogant urban elite with a compulsion to live out *their* fantasy at *our* expense" (italics in original)—which is a remarkably accurate description of statists of any stripe.

Another man from Arizona stated that this idea "illustrates all the absurd flaws in the ecocentric mind—. . . that balanced ecosystems don't include humans, [and] that government coercion can override human nature." Absurd, yes. . . but no more so than might describe the mind-sets of Marx or Lenin. Unfortunately, the "absurd flaws" of

their political system did not prevent them from imposing it across a significant fraction of the globe over a seventy year time span. The idea of the Wilderness Project is still relatively new and controversial, yet its supporters may become powerful beyond any rational expectations.

Some of those advocates believe it is important to "halt the spread of nature's most dangerous predator and competitor"; that lands should be cared for by people "who wish to restore themselves to a natural (i.e., tribal) state"; that "27 representatives" and "over 50 scientists also support the Northern Rockies Ecosystem Protection Act."

Even if the Wildlands Project itself is not implemented, its very radicalism makes other, more subtle eco-fascist strategies seem reasonable. This kind of strategy has been used repeatedly in the environmental movement: push an outlandish policy then propose something even crazier so the first proposal appears rational in comparison. Given the plethora of environmental laws strangling our country and shredding our property rights, this approach has been an effective one.

As has been pointed out by other writers, collectivists and statists who have been unable to achieve the degree of control they desire over our society through economic arguments have shifted their plan of attack to a "moral" appeal based on the false premises of "intrinsic value," "animal rights," and the supposed imminent destruction of the very environment upon which we depend for survival.

A new coat of paint, however, does nothing to alter the essence of who these eco-fascists are and what they believe. As a song from the Sixties said, the new boss is the same as the old boss. The struggle against collectivism is far from over: it has merely shifted to a new playing field. And as do most collectivists, the eco-fascists say they want to do this to us "for our own good." □

1. Elizabeth Pennis, "Conservation's Ecocentrics," *Science News*. 9-11-93, pp. 168-170.

2. *Science News*, "Letters," 11-20-93, pp. 323, 334.

Herbert Spencer: Liberty and Unlimited Human Progress

by Jim Powell

Fabled steel entrepreneur Andrew Carnegie hungered to know the secret of human progress. During the early 1880s, he found out after he joined a Manhattan discussion group. There he heard about British philosopher Herbert Spencer, who had written volumes on the subject. Liberty, Spencer explained, is the key as free markets—without government intervention—provide powerful incentives for people to continuously improve life.

Apparently, Carnegie was overwhelmed to realize that his daily work served a much larger purpose, promoting a beneficent social order. He adopted as his motto: “All is well since all grows better.”

The more Carnegie read by Spencer, the more he wanted to meet the philosopher. “Few men have wished to know another man more strongly than I to know Herbert Spencer,” Carnegie recalled. Through a mutual acquaintance, the British classical liberal John Morley, he got a letter of introduction and arranged to travel with Spencer on a steamship from Liverpool to New York.

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Carnegie discovered that Spencer—whom he had imagined as a “great calm philosopher brooding, Buddha-like, over all things”—was a human being. Spencer, then in his sixties, was of moderate height and reasonably thin. Although his hairline had receded, his hair remained brown, and it was fluffed out at the sides. He complained about his difficulty sleeping. He suffered from nervous ailments. He was quick to criticize the work of others, sensitive to criticism himself but honest enough to acknowledge his errors. He seemed unhappy living alone, as he lamented: “One who devotes himself to grave literature must be content to remain celibate; unless, indeed, he obtains a wife having adequate means for both. . . . Even then, family cares and troubles are likely to prove fatal to his undertakings.”

In June 1891, Carnegie surprised Spencer by delivering a token of his appreciation. Spencer wrote Carnegie: “I was alike astonished and perplexed on entering my room yesterday evening to see placed against the wall a magnificent grand piano. . . . I have all along sympathized in your view respecting the uses of wealth, but it never occurred to me that I should benefit by the carrying of your view into practice.”

Carnegie was among the millions inspired by Spencer then and now. He revived the revolutionary battle cry for natural rights that had been trashed by British philosopher Jeremy Bentham and his followers, the Utilitarians. Spencer showed why the theory of evolution, which naturalist Charles Darwin documented, meant that human progress occurs spontaneously as long as people are free, and governments stay out of the way. He stood as the most passionate defender of liberty when socialism and militarism gathered momentum throughout Europe.

Spencer was a prolific writer who produced books and articles on biology, education, ethics, psychology, sociology, and government policy, among other subjects. He had a gifted pen—coining, for example, the phrase “survival of the fittest.” From the 1860s till his death on December 8, 1903,

authorized editions of Spencer's books reportedly sold 368,755 copies in the United States alone—a remarkable number for a serious author. Supreme Court Justice Oliver Wendell Holmes doubted that “any writer of English except Darwin has done so much to affect our whole way of thinking about the universe.”

A Fiercely Independent Mind

Spencer was born in Derby, England, on April 27, 1820. His father George Spencer struggled for years to develop a career. He repeatedly tried manufacturing lace, then fashionable, but failed. He earned a little money teaching school. Friends suggested that he work at a tannery or become a clergyman. Spencer's mother, Harriet Holmes, didn't have it any easier: while she gave birth to five boys and four girls, only Herbert survived beyond age two.

He gained a fiercely independent mind from his Quaker parents. “Individuality was pronounced in all members of the family,” he recalled, “and pronounced individuality is necessarily more or less at variance with authority. A self-dependent and self-asserting nature resists all such government as is not expressive of equitable restraint.”

His formal education was limited—three years in one elementary school, then for an unknown (probably brief) time he attended his uncle William's school and was intermittently tutored by his uncle Thomas, a clergyman. By age 11, he seemed to be on his own, reportedly attending a science lecture. When his father was teaching physics and chemistry, the lad helped prepare experiments. He taught himself about plants and animals. He became good at sketching things. He learned much by listening when friends of his parents visited to talk about politics, religion, science, right and wrong. His father belonged to the Derby Philosophical Society which had a modest library of science books and periodicals, and he browsed through those.

He was 15 when his first article—about boats—was published in a little magazine. “I found *my article* looking very pretty,” he

noted at the time. “I began shouting and capering about the room. . . . And now that I have started I intend to go on writing things.”

Meanwhile, Spencer needed steady pay. A railroad-building boom was underway, and in November 1837, he got a job producing engineering drawings for the London and Birmingham Railway. Ever resourceful, he also invented several railroad-related measuring devices and wrote seven articles for *Civil Engineer's and Architect's Journal*. After four years, he had saved some money and decided to take time off to pursue a writing career. He attended meetings of free trade, anti-slavery, and anti-state-church groups. He wrote a dozen articles about political philosophy for *The Nonconformist*, a radical journal. These were subsequently reprinted as a pamphlet, *On the Proper Sphere of Government*.

Spencer was still a long way from being able to earn a livelihood writing, so he returned to railroad work as a draftsman for three years. He continued to read all kinds of books and keep himself informed about public affairs. In November 1848, he was offered an editorial position at the *Economist*, the free trade journal, where he worked for five years. One of the editors was Thomas Hodgskin, a philosophical anarchist who might have influenced him.

Social Statics

Spencer used spare time to write his first book, *Social Statics*, and it was published in 1851. He presented an inspiring moral and practical case for individual rights which he called “equal freedom.” Everyone should be free to do what he wishes, Spencer insisted, as long as he doesn't infringe on somebody else's equal freedom. Accordingly, he advocated abolishing all trade restrictions, taxpayer church subsidies, overseas colonies, medical licensing, legal tender laws, central banks, government schooling, government welfare, government postal monopolies, and so-called “public works.”

Spencer showed how self-interest leads

people not only to achieve prosperity—as Adam Smith had explained—but to improve life in countless ways. For example, Spencer had this to say about sanitation: “Although everyone knows that the rate of mortality has been gradually decreasing and that the value of life is higher in England than elsewhere—although everyone knows that the cleanliness of our towns is greater now than ever before and that our spontaneously grown sanitary arrangements are far better than those existing on the Continent, where the stinks of Cologne, the uncovered drains of Paris, the water tubs of Berlin, and the miserable footways of the German towns show what state management effects—although everyone knows these things, yet it is perversely assumed that by state management only can the remaining impediments to public health be removed.”

The most famous chapter was 19—“The Right to Ignore the State.” Even during the heyday of classical liberalism, it was bold for Spencer to declare that “If every man has freedom to do all that he wills, provided he infringes not the equal freedom of any other man, then he is free to drop connection with the state—to relinquish protection and to refuse paying toward its support. It is self-evident that in so behaving he in no way trenches upon the liberty of others, for his position is a passive one, and while passive he cannot become an aggressor.”

Social Statics established Spencer as a rising star, and by July 1853, he had resigned from the *Economist*, determined to make it as an independent author. He sold articles to the *Westminster Review*, *Edinburgh Review*, *Fortnightly Review*, *British Quarterly*, and other influential publications. He applied his ideas to science as well as ethics and government policy.

Financially, Spencer was hard-pressed and for a while pursued a cushy government job which would allow him time to write, but fortunately he never became a bureaucrat. A proud man, he declined John Stuart Mill’s generous offer to cover his expenses. He resolved to earn his living in the marketplace. By 1860, Spencer conceived the idea

of integrating ethics, biology, psychology, and sociology into a multi-volume work on philosophy—and making the venture pay by soliciting subscribers who would pay a half-crown for each installment, several times a year. He asked his famous friends to offer testimonials, and some 450 people became subscribers. Among his early subscribers were respected American intellectuals like newspaperman Horace Greeley, historian George Bancroft, clergyman Henry Ward Beecher, botanist Asa Gray, political scientist Francis Lieber, and abolitionist Charles Sumner. Spencer began working on *First Principles*, a book about the development of life.

Alas, Spencer experienced subscriber attrition like everyone else in the publishing business. When he no longer got enough income from the project, he announced he would discontinue it. But in 1865, Dr. Edward Youmans, a lecturer and founder of *Popular Science* magazine who had become a big fan of Spencer’s, helped raise about \$7,000 from American friends. This was enough for Spencer to continue.

Again and again, Spencer emphasized how extraordinary human progress develops naturally when people are free. Consider this passage from *Principles of Sociology*:

The turning of the land into a food-producing surface cleared, fenced, drained, and covered with farming appliances, has been achieved by men working for individual profit not by legislative direction . . . villages, towns, cities, have insensibly grown up under the desires of men to satisfy their wants . . . by spontaneous cooperation of citizens have been formed canals, railways, telegraphs, and other means of communication and distribution. . . . Knowledge developing into science, which has become so vast in mass that no one can grasp a tithe of it and which now guides productive activities at large, has resulted from the workings of individuals prompted not by the ruling agency but by their own inclinations. . . . And supplementing these come the innu-

merable companies, associations, unions societies, clubs, subserving enterprise, philanthropy, culture, art, amusement; as well as the multitudinous institutions annually receiving millions by endowments and subscriptions; all of them arising from the unforced cooperations of citizens. And yet so hypnotized are nearly all by fixedly contemplating the doings of ministers and parliaments, that they have no eyes for this marvelous organization which has been growing for thousands of years without governmental help—nay, indeed, in spite of governmental hindrances.

Spencer anticipated the work of Nobel Laureate F.A. Hayek who reminded the world why spontaneous market action, not central planning, is responsible for humanity's most stunning achievements.

Spencer had his greatest impact in America where people were eagerly building a new civilization. By 1864, *Atlantic Monthly* reported: "Mr. Herbert Spencer is already a power in the world . . . represents the scientific spirit of the age." His principles, the magazine concluded, "will become the recognized basis of an improved society." Yale sociologist William Graham Sumner emerged as the greatest American champion of Spencer's ideas.

Despite Spencer's heroics, public opinion increasingly favored government intervention during the late nineteenth century. Perhaps this was because government had been cut back so much that it no longer seemed like a public menace. More people imagined government could do good. Spencer responded by writing four powerful articles which affirmed the bedrock principles of laissez faire and attacked government intervention, published in the *Contemporary Review*, 1884. They unleashed what he called "a hornet's nest about my ears in the shape of criticisms from the liberal journals." In July 1884, the articles were gathered together for a book, *The Man Versus The State*.

It was a magnificent performance as Spencer hammered his adversaries—socialists

especially—with dramatic facts to show why laws almost always backfire. He told how government-enforced interest-rate ceilings, supposedly enacted to help people, made it more difficult to borrow money. He recalled how price controls triggered the disappearance of food from markets, and many people starved. He documented how well-meaning London officials demolished homes for 21,000 people, built new homes for only 12,000 and left 9,000 homeless—anticipating identical attacks which would be leveled against U.S. government "urban renewal" programs during the late twentieth century. American journalist Henry Hazlitt called this "one of the most powerful and influential arguments for limited government, laissez faire, and individualism ever written."

Spencer was apparently depressed by accusations that he was superficial and heartless, and in 1892 he approved a revised edition of *Social Statics* without the original chapter 19, "The Right to Ignore the State." This compromise hardly satisfied critics. Justice Oliver Wendell Holmes, defending New York's regulation (of working hours) in 1905, two years after the philosopher's death, thought it necessary to denounce him by name: "The Fourteenth Amendment does not enact Mr. Herbert Spencer's *Social Statics*."

Yet the twentieth century, bloodiest in history, has shown Spencer to be a phenomenal prophet. More loudly and clearly than anyone during his lifetime, he warned that socialism must lead to slavery. He condemned militarism long before a European arms race exploded into the First World War. He anticipated the evils of welfare state policies that undermine incentives for poor people to achieve independence. He predicted the colossal failure of government schools. He affirmed that private individuals are responsible for human progress. He would be thrilled by the world-wide resurgence of market economies today, vindicating his conviction that wherever governments interfere least, you will see decency and improvement in the lives of ordinary people. □

The U.S. Banking Debacle of the 1980s: A Lesson in Government Mismanagement

by George G. Kaufman

I. Introduction

In the 1980s, the United States experienced its most serious banking crisis since the 1930s and the second most serious crisis in its 200-plus year history. The crisis affected commercial banks, savings banks, and savings and loan associations (S&Ls). Between 1980 and 1991, when fundamental corrective laws were enacted, some 1,500 commercial and savings banks (insured by the Federal Deposit Insurance Corporation) and 1,200 savings and loan associations (insured by the former Federal Savings and Loan Insurance Corporation) failed and were resolved by the regulatory agencies. These resolutions represented about 10 percent of all banks at the beginning of the period and 25 percent of all S&Ls. In addition, an even larger number of institutions were in precarious financial condition

at some time during this period. The costs of the failures were high, not only to the shareholders of the failed institutions, but also to the surviving institutions, which were required to pay premiums to the deposit insurance agencies, and to U.S. taxpayers, who were forced to make good on the losses after the resources of the S&L insurance fund had been exhausted. For banks, the loss to the FDIC and thus to other solvent banks was about \$40 billion. For S&Ls, the loss was near \$200 billion, some \$150 billion of which was beyond the resources of the FSLIC and was therefore charged to U.S. taxpayers.

The losses accrued primarily to the federal insurance agencies and taxpayers rather than to depositors and other creditors because the insurance effectively guaranteed the par value of deposits up to \$100,000 per account *de jure* and, except at some small banks, almost any amount of deposits and even borrowings *de facto*, regardless of the value of the bank's assets. The FDIC and the former FSLIC were funded by premiums imposed on banks and S&Ls, respectively, and both had implicit access to the U.S. Treasury that legislators were unwilling either to challenge or to make explicit until near the end of the debacle.

The crisis ended in the early 1990s, when

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interest rates declined, the yield curve turned steeply upward sloping, a series of rolling geographic recessions in various regions of the country came to an end, the aggregate economy slowly expanded, the real estate market bottomed out, and newly adopted legislation increased the cost of poor performance and failure to both the institutions and the regulators. By 1994, both the banking and thrift industries were in their best financial condition since the early 1960s and were realizing record profits. The number of failed and problem institutions declined sharply.

II. Background

Banking has always been a volatile industry in the United States, but until the 1930s not an unusual one.¹ The annual failure rate for commercial banks from 1870 to 1913, before the establishment of the Federal Reserve System, averaged 0.78 percent compared to 1.01 percent for nonbanks. The annual volatility of the failure rate was greater for banks, however. The relatively low failure rate existed despite a banking structure that favored failures by restricting banks to one or at best only a few offices, thus preventing them from reducing risk through geographical and product diversification. As a result, the country had thousands of independent banks; the number peaked at 30,000 in the early 1920s. The bank failures increased sharply in the 1920s to near 600 per year, but most of the failures were very small banks. Some 90 percent of the banks had loans and investments of less than \$1 million, which adjusted for inflation would be equivalent to only about \$10 million currently, and would rank them among the very smallest banks. Their failure had no visible effect on national economic activity. They were primarily located in small agricultural towns in the midwest. When a recession hit these towns from the rapid fall in farm prices after the post-World War I runup, the local automobile dealer failed, the local drugstore failed, and the local bank failed.

But things changed dramatically in the

1930s at the onset of the Great Depression. Between 1929 and 1933, the number of banks declined from 26,000 to 14,000, mostly by failure. Indeed, the very first act of newly elected President Franklin D. Roosevelt was to declare a "bank holiday" and close all banks in the country for at least one week in order to prevent depositors from cashing any more of their deposits into currency. The banks were permitted to reopen if the government found them solvent. Thereafter, banking became a relatively stable industry through the late 1970s. The number of bank failures averaged only near 10 per year and the number of S&L failures was not significantly greater. Then the picture changed again.

Before analyzing the 1980s, it should be noted that both the 1930s and 1980s debacles occurred after the creation of government institutions intended to correct failings in the system that were believed to have been at the root of the problem, and in order to reduce the likelihood of large numbers of simultaneous failures in the future. The Federal Reserve was established in 1913 in the aftermath of sharp jumps in the number of bank failures in 1894 and 1907 in order to increase flexibility in the system. The Fed was to facilitate the flow of bank reserves from capital surplus to capital deficient areas, to provide micro-liquidity through the discount window to individual solvent banks experiencing temporary liquidity problems, and to provide macro-liquidity to the banking system by offsetting outflows of currency and gold. For whatever reasons, not 20 years after it was established, the Fed failed to achieve these objectives sufficiently to prevent the banking crisis of the 1930s, which was far larger, longer, and costlier than any banking crisis before the establishment of the Fed. Indeed, the Fed appears to have introduced greater rigidities at the time of the Great Depression, e.g., prohibiting the issuance of clearing house certificates and making temporary bank suspensions more difficult, than existed before its establishment.²

In large part as a result of the Fed's failure to prevent a recurrence of large-scale bank

failures, the FDIC was established in 1934. While the Fed's decisions to provide liquidity to the banking system in order to offset depositor runs into currency were discretionary, the FDIC operated by rules that effectively eliminated the need for bank runs by unconditionally guaranteeing the par value of insured deposits regardless of the bank's financial condition. This objective was quickly realized and, combined with a more cautious set of bankers and more restrictive regulations imposed by the Banking Act of 1933, the number of bank failures dropped equally quickly and remained low for the next 50 years. However, as was true of the Federal Reserve's structure, flaws eventually appeared in the FDIC that in time led to increases in bank failures that matched the conditions in the 1930s before the introduction of deposit insurance.

III. The S&L Debacle³

Savings and loan institutions are traditional residential mortgage lenders. Before the introduction of deposit insurance in 1934, S&Ls made primarily intermediate three-to-five-year renewable mortgage loans. These loans were effectively variable rate mortgages with sizeable down payments. They were financed by time deposits (legally labeled share capital), which were not necessarily redeemable on demand. As a result, neither the S&Ls' interest rate nor liquidity exposures were very great.

But things changed dramatically after 1934. Public policy encouraged S&Ls to make progressively longer-term (first 20, then 25, and finally 30-year) fixed-rate mortgages with progressively smaller down payments. At the same time, the new deposit insurance program effectively increased the liquidity and shortened the maturity of their deposits. These changes increased the institutions' exposure to interest rate and liquidity risk. Indeed, the large degree of maturity (duration) mismatch by the mid-1970s made the industry a disaster waiting to happen.

When interest rates increased sharply in the late 1970s as a result of inflation, the

disaster occurred. Between 1976 and 1980, interest rates on three-month Treasury bills jumped from 4 percent to 16 percent and those on long-term Treasury securities from 6 percent to 13 percent. By 1982, an estimated 85 percent of all S&Ls were losing money and two-thirds were economically or market value insolvent so that, *ceteris paribus*, they would be unable to pay their depositors in full and on time. The negative economic net worth of the industry and the corresponding loss to the FSLIC was generally estimated to be about \$100 billion,⁴ although some estimates placed it as high as \$150 billion. This figure represents the difference between the par value of deposit accounts (the large majority of which were less than the maximum insured \$100,000 per account) at insolvent institutions and the market value of the S&Ls' assets. But the FSLIC resolved only a very small number of the insolvencies for a number of reasons, including:⁵

- It was overwhelmed by the large number of insolvencies, and its staff was far too small and unprepared to deal with the crisis,
- It had insufficient reserves to cover the deficits at insolvent institutions and pay off depositors at par, whether the institutions were sold, merged or liquidated,
- Formal recognition of the large losses would be a black mark on the agency's record,
- Formal recognition of the large losses and number of insolvencies might spread fear among the public and ignite a run on all institutions that would spill over to commercial banks and even beyond to the macro-economy. Further,
- Many of the losses were "only" unrecognized paper losses; and, because interest rates are cyclical and there was a high probability that they would decline again in the not very distant future, it was hoped that waiting would restore the associations to economic solvency.

Therefore, regulators publicly denied the magnitude of the problem, argued that the problem was a liquidity rather than a solvency problem, introduced creative accounting measures to make the industry's

net worth appear higher even than the already overstated book value levels (i.e., they covered up the evidence), delayed imposing sanctions on insolvent and near-insolvent institutions, and encouraged institutions to reduce their interest rate exposure by using newly permitted variable-rate mortgages and shorter-term loans to reduce their maturity mismatch. And the regulators and the industry lucked out. Interest rates declined sharply from 1982 through 1986. This reversal in rates caused the industry's net worth to rise and by 1985 its estimated negative net worth was only about \$25 billion and was expected to improve further, *ceteris paribus*.

But *ceteris* did not remain *paribus* for many institutions. A substantial number incurred increases in credit risk that offset the decline in interest rate risk and either prevented their net worth from increasing greatly or actually caused it to decline further. The assumption of credit risk was either unintentional, arising from severe local and regional economic recessions, or intentional, arising from calculated gambles to regain solvency.

The first and most severe regional recessions started in the mid-1980s in Texas and the neighboring energy-producing states in the Southwest following the collapse of world oil prices. This area had experienced a strong economic surge based on sharply rising oil prices and expectations of continued price increases. Employment, income, and real estate values all increased sharply and stimulated both a rapid immigration of people in search of employment and a building boom, particularly in commercial real estate. Much of this boom was financed by local S&Ls. When oil prices not only failed to increase further after 1981, but declined sharply from \$30 a barrel in 1985 to near \$10 in 1986, the bubble burst.⁶ As incomes and real estate values dropped, borrowers defaulted on loans, and collateral values fell too fast for many lending S&Ls to protect the value of all their loans. As a result, many S&Ls became insolvent.

At the same time, a number of institutions, particularly those that had only re-

cently converted from mutual ownership (which was the prevailing form of ownership) to stock ownership in order to raise additional capital more easily, became tempted to "gamble for resurrection." Because these institutions had little if any market value capital of their own to lose, this was a logical strategy. If the high-risk bets paid off, the institution won and possibly regained solvency. If the institution lost, the FSLIC bore the loss. That is, heads the institution won, tails the FSLIC lost! Some S&Ls placed progressively larger bets on the table by offering above market interest rates on deposits so that their deposit size grew rapidly. Such gambling was often accompanied by fraud, either *ex-ante* deliberate or *ex-ante* inadvertent through excessive carelessness in extending and monitoring loans. Particularly at the more rapidly growing associations, loan documentation was frequently incomplete or even nonexistent, record keeping casual at best, and loan collection was sporadic and done with little enthusiasm. Some of the new owners were land developers, who are gamblers almost by nature. They used greatly overinflated values of their personal properties as the base for their institution's capital, and the resources of the institution as their personal "piggy banks" to finance their ventures. Losses were often not recognized on the institutions' books on a complete or timely basis, so that the institutions gave false appearances of solvency.

The National Commission appointed in 1992 to identify and examine the origins and causes of the S&L debacle concluded that: "It is difficult to overstate the importance of accounting abuses in aggravating and obscuring the developing debacle. It would have been difficult for the process to continue for so long in the absence of an information structure that obscured the extent of the mounting losses."⁷ The FSLIC economic deficit (computed as the difference between the par value of insured deposits at economically insolvent S&Ls and the market value of their assets), which had declined from some \$100 billion in 1982 to near \$25 billion in 1985, climbed back up to

above \$100 billion in 1989, almost entirely due to losses from credit risk exposure.

Commercial banks were not as badly hit by the interest rate increase in the late 1970s because the maturities on the two sides of their balance sheets were not as mismatched. But, like the S&Ls, they experienced large credit losses in the mid and late 1980s that resulted in the largest number of bank failures since the 1930s and the second largest number in U.S. history. These losses threatened to bankrupt the FDIC.

IV. Structured Early Intervention and Resolution and Deposit Insurance Reform

The S&L and bank problems were in large part caused by deposit insurance. The structure of deposit insurance adopted in 1933 had both good and bad aspects. The good aspect effectively prevented a systemwide run from deposits into currency by guaranteeing the par value of most deposits. Thus, it prevented the type of reserve drain experienced in the United States in the early 1930s.

The bad aspects were, first, that this guarantee reduced, if it did not eliminate, the incentive for many depositors to monitor the financial performances of their banks and thus encouraged both a moral hazard problem for banks and a principal-agent problem for regulators. Bank managers/owners, knowing that few if any depositors were looking over their shoulders and that their insurance premiums were not scaled to their risk exposure, deliberately or inadvertently assumed greater risks either by increasing the credit and interest rate risk exposures in their portfolios and/or by decreasing their capital-asset ratios more than they would have in the absence of insurance. Bank regulators, knowing that most depositors had little if any incentive to flee financially troubled banks, were then able to delay imposing sanctions on troubled institutions and even resolving insolvent institutions, thereby keeping them in operation. To the extent that these insti-

tutions increased their losses, the regulators' principals—healthy, premium-paying institutions and taxpayers—were not well served.⁸

In an attempt to solve the problem, Congress at year-end 1991 enacted the FDIC Improvement Act (FDICIA), which focusses on structured early intervention and resolution (SEIR). SEIR reforms deposit insurance by attempting to impose on insured depository institutions the same conditions that the private market imposes on firms not covered by federal insurance whose financial condition is deteriorating, including conditions that the banks themselves impose on their borrowers. Moreover, it attempts to resolve troubled institutions before their own capital turns negative. Thus, losses would accrue only to shareholders, not to depositors, and deposit insurance would effectively be redundant.

SEIR's objective is also to reduce the discretion of regulators by imposing more specific rules, thus reducing the power of regulators. As such, it resembles the partial replacement of Federal Reserve discretion by FDIC insurance rules following the Fed's failure to prevent the banking crisis and economic depression of the early 1930s.⁹ To protect their power, the regulators successfully fought to weaken many of the provisions reducing their discretionary authority during the legislative processing leading to the enactment of FDICIA and continued to weaken the potential effectiveness of the Act further by drafting weak regulations to implement it.¹⁰

V. The Lesson

An analysis of the experience of the U.S. banking debacle of the 1980s suggests that to minimize the moral hazard problem federally insured depository institutions should be subjected to the same conditions imposed by the private market on noninsured firms and that to minimize the regulators' principal-agent problem the insurer and other bank regulatory agencies should be required to operate in a transparent manner, be prohibited from providing forbearance, and

be held fully accountable for their actions and inactions.

The major source of both the instability in the U.S. banking system in the 1980s that resulted in the exceptionally large number of bank and S&L failures and the associated large losses was not the private sector but the public or government sector. The government first created many of the underlying causes of the problem by forcing S&Ls to assume excessive interest rate risk exposure and preventing both S&Ls and banks from minimizing their credit risk exposure through optimal product and geographic diversification and then delayed in applying solutions to the problem by granting forbearance to economically insolvent or near-insolvent institutions. That is, the banking debacle was primarily an example of government failure rather than market failure. □

1. A brief history and additional references appear in George J. Benston, Robert A. Eisenbeis, Paul M. Horvitz, Edward J. Kane and George G. Kaufman, *Perspectives of Safe and Sound Banking*, Cambridge, Mass.: MIT Press, 1986, Chapter 2.

2. Milton Friedman and Anna J. Schwartz, *A Monetary History of the United States 1867-1960*, Princeton, N.J.: Princeton University Press, 1963, Chapter 7.

3. Although savings banks have more in common with S&Ls than commercial banks, because they were insured by the FDIC rather than the FSLIC, data on them is included with that for commercial banks.

4. See Bert Ely, "Savings and Loan Crisis" in David R.

Henderson, ed., *Fortune Encyclopedia of Economics*, New York: Warner Books, 1993, p. 72.

5. Edward J. Kane, *The Gathering Crises in Federal Deposit Insurance*, Cambridge, Mass.: MIT Press, 1985; *The S&L Insurance Mess: How Did It Happen?* Washington, D.C.: Urban Institute Press, 1989, James R. Barth, *The Great Savings and Loan Debacle*, Washington, D.C.: American Enterprise Institute, 1991; George G. Kaufman, "The Savings and Loan Rescue of 1989: Causes and Perspective" in George G. Kaufman, ed., *Restructuring the American Financial System*, Boston: Kluwer Academic, 1990; George J. Benston and George G. Kaufman, "Understanding the Savings and Loan Debacle," *The Public Interest*, Spring, 1990, pp. 79-95; National Commission on Financial Institution Reform, *Recovery and Enforcement, Origins and Causes of the S&L Debacle: A Blueprint for Reform—Report to the President and Congress of the United States*, Washington, D.C., July 1993; Martin Lowy, *High Rollers: Inside the Savings and Loan Debacle*, New York, Praeger, 1991; and Martin Mayer, *The Greatest Ever Bank Robbery: The Collapse of the Savings and Loan Industry*, New York: Charles Scribner, 1990.

6. Paul M. Horvitz, "The Collapse of the Texas Thrift Industry" in George G. Kaufman, ed., *Restructuring the American Financial System*, Kluwer, 1990, pp. 95-116.

7. National Commission, p. 9.

8. Edward J. Kane, "Changing Incentives Facing Financial-Services Regulators," *Journal of Financial Services Research*, September 1989, pp. 265-274 and Edward J. Kane, "How Market Forces Influence the Structure of Financial Regulation" in William S. Haraf and Rose Marie Kushmeider, eds., *Restructuring Banking and Financial Services in America*, Washington, D.C.: American Enterprise Institute, 1988, pp. 343-382.

9. The battle between rules and discretion in banking regulation resembles the more publicized and longer-run battle between rules and discretion in the conduct of monetary policy carried on in the U. S. at least since the 1930s.

10. George J. Benston and George G. Kaufman, "Improving the FDIC Improvement Act: What Was Done and What Still Needs to be Done to Fix the Deposit Insurance Problem" in George G. Kaufman, ed., *Reforming Financial Institutions and Markets in the United States*, Boston: Kluwer Academic, 1994, pp. 99-120; and Kenneth E. Scott and Barry R. Weingast, "Banking Reform: Economic Propellants, Political Impediments" in George G. Kaufman, ed., *Reforming Financial Institutions and Markets in the United States*, 1994, pp. 19-36.

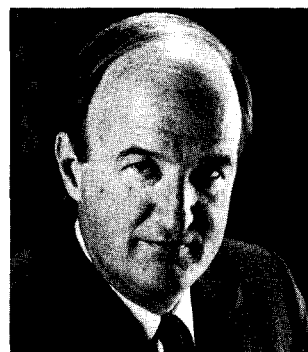
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Bankers and Regulators

The current U.S. financial structure, in despair and disrepute, is the logical outcome of financial thought that places legislators and regulators in the center of things. It is a precarious system that builds on government insurance and government guarantees and, in final analysis, depends on monopoly money and legal tender force. It is a discredited system that is inflicting immeasurable harm on many people.

The seventeen essays in this volume, all selected from earlier issues of *The Freeman*, examine in detail the failure of regulation and offer hope for a return to sound banking. The collection includes, among others, articles by Hans F. Sennholz, Ken S. Ewert, E.C. Pasour, Jr., Kurt Schuler, Richard M. Salsman, and Lawrence H. White.

176 pages, indexed, \$14.95 paperback



Friedman vs. The Austrians, Part II: Was There an Inflationary Boom in the 1920s?

“I have no reason to suppose there was any over-investment boom . . . during the 1920s.”
—Milton Friedman

In my continuing exchange of letters with Professor Milton Friedman, the free-market economist challenged followers of the Austrian school to provide evidence of an overinvestment boom in the 1920s. He reiterated what he and Anna Schwartz concluded in *A Monetary History of the United States*: the 1920s was the “high tide” of Federal Reserve policy, inflation was virtually non-existent, and economic growth was reasonably rapid. Monetarists even deny that the stock market was overvalued in 1929! In short, “everything going on in the 1920s was fine.”¹ The problem, according to Friedman, was not the 1920s, but the 1930s, when the Federal Reserve permitted the “Great Contraction” of the money supply and drove the economy into the worst depression in U.S. history.

In contrast to Friedman and the Monetarists, the Austrians argue that the Federal Reserve artificially cheapened credit during most of the 1920s and orchestrated an unsustainable inflationary boom. The stock market crash of 1929 and subsequent economic cataclysm were therefore inevitable.

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An interesting historical sidelight is the fact that Irving Fisher, the principal Monetarist of the 1920s, completely failed to anticipate the crash, while Austrian economists Ludwig von Mises and Friedrich Hayek predicted the economic crisis, although they did not pinpoint an exact date. Ever since then, Monetarists have argued that the 1929–33 debacle was unforecastable and have made every effort to show that there were few if any signs of trouble during the 1920s. The Austrians, in contrast, have attempted to confirm Mises-Hayek’s view that the government created an inflationary boom that could not last, especially under an international gold standard.²

Was there an overinvestment boom in the 1920s? The answer depends on which statistics you examine. The “macro” data favors the Monetarists’ thesis, while the “micro” data supports the Austrians’ view.

In support of the Monetarists, the broad-based price indices show little if any inflation. Average wholesale and consumer prices hardly budged between 1921 and 1929. Most commodity prices actually fell. Friedman and Schwartz conclude, “Far from being an inflationary decade, the twenties were the reverse.”³

However, other data support the Austrian view that the decade was aptly named the Roaring Twenties. The 1920s may not have been characterized by a “price” inflation, but there was, in the words of John Maynard Keynes, a “profit” inflation. After the 1920–21 depression, national output (GNP)

grew rapidly at a 5.2 percent pace, substantially exceeding the national norm (3.0 percent). The Index of Manufacturing Production grew much more rapidly and virtually doubled between 1921 and 1929. So did capital investment and corporate profits.

Like the 1980s, there was also an "asset" inflation in the U.S. A nationwide real estate boom occurred in the mid-1920s, including a speculative bubble in Florida that collapsed in 1927. Manhattan, the world's financial center, also experienced a boom.

The asset bubble was most pronounced on Wall Street, both in stocks and bonds. The Dow Jones Industrial Average began its monstrous bull market in late 1921 at a cyclical low of 66, mounting a drive that carried it to a high of 300 by mid-1929, more than tripling in value. The Standard & Poor's Index of Common Stocks was just as dramatic—Industrials, up 321 percent, Railroads, up 129 percent, and Utilities, up an incredible 318 percent.

Astonishingly, the Monetarists go so far as to deny any stock market orgy. Anna Schwartz suggests, "Had high employment and economic growth continued, prices in the stock market could have been maintained."⁴ It's as if they want to exonerate Irving Fisher's infamous blunder of declaring a week before the 1929 crash, "stock prices have reached what looks like a permanently high plateau." (Fisher's huge leveraged position in Remington Rand stock was wiped out by the crash.)

Schwartz's thesis is based on what appears to be reasonable price-earnings ratios for most stocks in 1929 (15.6 versus a norm of 13.6). However, P/E ratios can be a notoriously misleading indicator of speculative activity. While they do tend to rise during a bull market, they severely underestimate the degree of speculation because *both* prices and earnings tend to rise during a boom. However, when annual national output averages 5.2 percent during the 1920s, and the S&P Index of Common Stocks increases an average 18.6 percent a year, something has to give. In fact, during 1927–29, the economy grew only 6.3 percent, while common stocks gained an in-

credible 82.2 percent! As the old Wall Street saw goes, "Trees don't grow to the sky." A crash was inevitable.

The Austrians argue that the Federal Reserve's "cheap-credit" policy was to blame for the structural imbalances of the Twenties, while the Monetarists dispute any significant inflationary intent. The money stock (M2) grew 46 percent between 1921–29, less than 5 percent per annum, which Monetarists do not consider excessive.⁵ Austrians, on the other hand, point to the deliberate efforts by the Fed to lower interest rates, especially in 1924 and 1927, thus generating an unjustifiable boom in assets and manufacturing. More importantly, the credit expansion in the United States far exceeded the increase in gold reserves, which would eventually spell disaster under the gold exchange standard.

In sum, was there an inflationary imbalance during the 1920s, sufficient to cause an economic crisis? The evidence is mixed, but on net balance, the Austrians have a case. In the minds of the Monetarists, the "easy credit" stimulus may not have been large, but given the fragile nature of the financial system under the international gold standard, small changes by the newly established central bank triggered a global earthquake of monstrous proportions.

In my next column, I will address a growing debate among economists: Did the gold standard make the 1929–33 crisis worse? □

1. Milton Friedman and Anna J. Schwartz, *A Monetary History of the United States, 1867-1960* (Princeton, N.J.: Princeton University Press, 1963), pp. 240–98.

2. See my article, "Who Predicted the 1929 Crash?" in Jeffrey M. Herbener, ed., *The Meaning of Ludwig von Mises* (Norwell, Mass.: Kluwer Publishers, 1993), pp. 247–83. Interestingly, John Maynard Keynes also failed to predict 1929–32, and lost three-fourths of his net worth.

3. *Monetary History*, p. 298.

4. Anna J. Schwartz, "Understanding 1929-1933," in *Money in Historical Perspective* (Chicago: University of Chicago Press, 1987), p. 130.

5. Friedman criticizes Murray Rothbard's inclusion of cash-value from life insurance policies as "pure chicanery" in an effort to inflate monetary figures. By doing so, Rothbard increases the money supply, 1921–29, by 61.7 percent instead of Friedman's more traditional 46 percent figure. See Murray Rothbard, *America's Great Depression*, 4th ed. (New York: Richardson & Snyder, 1983 [1964]), p. 88 *passim*. I tend to side with Friedman on this issue.

BOOKS

Perpetuating Poverty: The World Bank, the IMF, and the Developing World

Edited by Doug Bandow and
Ian Vásquez

Cato Institute • 1994 • 362 pages • \$15.95
paperback

Reviewed by Ken Ewert

There is a biblical proverb that says: “the tender mercies of the wicked are cruel.” I have often thought of this verse in relation to the misery that political policies such as rent control or minimum wages have caused people—especially the poorest of people. The “tender mercies” of governments—attempts to use the law as an instrument of compassion—often turn out to be cruel to the intended beneficiaries, the poor. With friends like most modern governments, the poor do not need any enemies.

Perpetuating Poverty demonstrates this to be true on an international scale. Fifty years and hundreds of billions of dollars of aid from Western governments—tunneled through the IMF, the World Bank, and a number of other multilateral aid agencies—have had an impact on world poverty: it has helped keep the Third World poor just that—poor.

Development economists have long held that the Third World is poor primarily because of its lack of capital. According to the conventional wisdom poor nations cannot, on their own, afford to save enough to break out of a subsistence-type economy. Their only hope is massive infusions of capital from the taxpayers of the West. They need Western wealth in order to “develop.” Furthermore, according to the popular Marxist notion of Western guilt for the exploitation of the poor nations, the Third World has a right to Western wealth.

It now seems beyond question that the

massive wealth transfers to Third World governments have not, in general, helped the poor. As the editors note in the introduction, “the multilaterals can point to few, if any, cases in which their efforts have led to improved living standards and sustained economic prosperity.” Forty years of international aid transfers have left Latin America with a foreign debt of \$430 billion, sub-Saharan Africa with per capita incomes lower today than they were in the 1970s, and India with an annual per capita income of around \$300.

Why has aid failed? Primarily because most developmental institutions lend to governments, and not to individuals. The recipient governments are often—through their destructive economic policies—the very cause of the economic problems that the aid seeks to rectify. International aid is, in effect, a subsidy to bad economic policies and a bloated public sector. It succeeds, not in alleviating poverty, but in extending and prolonging bureaucratic control over the poor of the Third World. Governments who would have been forced to change or collapse have instead been kept afloat by loans from the World Bank or the IMF and allowed to continue their destructive policies. This is something like an international welfare program, not for the poor of the Third World, but for their governments. Much aid has been wasted in poorly planned, ill-administered projects of little benefit—such as crop-storage depots built where peasants never go, or funds allotted to buy a profitable private bus line in India and turn it into a money-losing public enterprise. Billions of dollars, collected from middle-class taxpayers of the West, have “aided” Third World elites to possess grand estates, private zoos, classic car collections, and Swiss bank accounts.

But this book does not merely look at the “bad cases”—it is a devastating critique of foreign aid in principle. Shyam Kamath, in his chapter on foreign aid and India’s Leviathan State, shows how foreign aid has allowed India to create and sustain one of the “world’s largest and most inefficient public sectors.” Robert Salinas León dem-

onstrates how World Bank loans allowed Mexico to expand its state-owned industries from 300 in 1970 to some 1,200 by 1982, and how IMF loans during the early 1980s helped postpone the privatization of major state corporations. James Bovard details how the World Bank helped finance the cruel "relocation" policies of Julius Nyerere's government in Tanzania, and the Mengistu government in Ethiopia. He also brings to light the Bank's complicity in the brutal collectivization policies of Vietnam in the late 1970s. Doug Bandow demonstrates how the IMF relieves the political pressure on Third World governments for a much needed reform of their economic policies. Surely the "tender mercies" of this type of aid have been bitterly cruel to the poor of the Third World. Surely Western taxpayers would be outraged if they knew that their money was going not to help the poor but to finance international socialism.

If the Third World is poor because it lacks capital, it lacks capital because it lacks economic freedom. It is no coincidence that the aid-recipient countries are characterized by state-sponsored monopolies, high taxation, onerous regulation, high inflation, extensive price controls, ambitious social programs, persistent budget deficits, and a general lack of private property rights. These things are not caused by poverty, they are the cause of poverty.

What the Third World so desperately needs is economic freedom and limited civil government. With these preconditions in place, the capital necessary for economic progress will be attracted. Prompted by Mexico's extensive free market reforms of the past few years, over \$40 billion of foreign capital has flowed in since 1988. Likewise, the small country of Chile (population 13.5 million) has attracted \$8.5 billion in foreign investment since its free market reforms in the mid-1970s. Countries that respect private property and economic freedom attract investment capital; countries that do not suffer "capital flight."

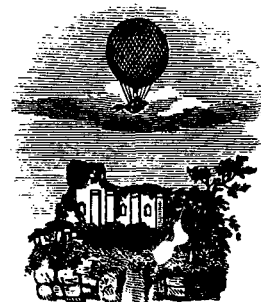
Foreign aid is inherently statist. Even when institutions such as the World Bank or the IMF do lecture countries on the need

for freer markets—as they have sometimes done in recent years—they simultaneously give the foreign governments the very means to resist that which they advise. It is analogous to lecturing a drug addict on the need for reform while giving him money to buy more drugs. As Paul Craig Roberts notes in his chapter, the leftists are partially correct: the West *does* bear some responsibility for the conditions of the Third World—not because of its capitalistic exploitation—but because of the statist consequences of its aid.

Perpetuating Poverty shows that what the Third World needs is not more dollars but the moral and political reform that underlie a free economy. The poor nations also need increased-trade with the West. As the last section of the book details, it is a striking hypocrisy that while Western governments continue to give billions of dollars in multilateral aid, they refuse to open their markets to Third World and former East-Bloc producers. In his chapter, J. Michael Finger calculates that developed countries' import restrictions "reduce developing countries' national income by about twice as much as developing countries receive in aid." This is a shame, for, as James Bovard writes, "charity is no substitute for opportunity."

The authors of this book, as Peter Bauer notes in his comment, are the best in their field. Their case against multilateral aid is well-documented, well-reasoned, and powerful. Their charges deserve an answer from those who continue to justify multilateral institutions. □

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Scarcity or Abundance? A Debate on the Environment

by Norman Myers and Julian Simon

W. W. Norton & Company • 1994 • 259 pages
• \$21.00

Reviewed by Jonathan H. Adler

On October 14, 1992, students at Columbia University gathered in the Kellogg Conference Center to witness a clash of worldviews. Cornucopian economist Julian Simon and apocalyptic ecologist Norman Myers were staging a debate on the future of human civilization and the natural environment. At issue was whether present rates of economic development, population growth, and environmental disruption pose a significant threat to humanity. The exchange that ensued, along with pre-debate statements and rebuttals, is included in *Scarcity or Abundance?*, a useful encapsulation of current environmental debates.

The approaches of Simon and Myers could not be more different. Simon, author of *Population Matters* and *The Ultimate Resource*, is a data-driven economist. His preferred mode of analysis is to ask "What do the numbers show?" By analyzing long-term trends, Simon believes it is possible to show significant improvement in virtually every material aspect of human welfare. To wit, he shows that people are living longer, healthier lives than ever before, while in many important respects environmental indicators show significant improvement over the past several decades. "Almost every economic and social change or trend points in a positive direction," he declares, adding "there is no persuasive reason to believe that these trends will not continue indefinitely." So confident is Simon that this will continue, he is willing to bet on it. Pick the trend, the time period, and the size of the wager, and Simon will take you on.

If Simon sees trends that can continue, Myers sees the end of progress. "We are at a watershed stage in human history," he counsels. Myers fears an "unparalleled threat" created by the forces of "environ-

mental decline in conjunction with rapid population growth." He is undaunted by holes in the data that purportedly make his case. The state of the world may seem rosy, but Myers sees a world "poised" on the brink of catastrophe. Human activity has finally reached a magnitude capable of initiating complete ecological collapse—an environmental "breakpoint." Urgent action is absolutely essential to ensure human survival. "No human community in the future will ever have our chance to save the planetary ecosystem," he warns, "because if we don't master the problems, they'll have nothing left to do but pick up the pieces we pass on to them."

This contrast in worldviews is certainly stark. One could even wonder if Simon and Myers could be speaking about the same world. Indeed, it is not clear that Myers and Simon recognize each others' critiques. *Scarcity or Abundance?* provides an excellent overview of the two contrasting positions, and is thus a valuable source of environmental information. Its disappointment is the limitation imposed by the debate format that prevents elucidation of the Myers and Simon positions. At times, arguments that could have clarified the two sides are left implicit in the text. This is not a serious failing, but at times it can leave those unfamiliar with environmental issues at a loss as to which side to believe.

That experts could find two separate sets of data to justify antithetical assessments of the earth's present condition would be amazing. Perhaps too amazing. Upon closer reflection one sees that the clash is not always between the data. As the debate over global warming centers around whether one places his faith in empirical evidence or speculative computer models, so too the Simon-Myers clash is about whether one trusts analysis or instinct. Time and again Myers responds to Simon's assertions of fact with speculative predictions of future want, often premised on the assumption that humanity has exhausted the possibility for technological advance. Some may find "it could happen" scenarios compelling, but after a while they lose their punch.

A good microcosm of the Simon/Myers clash is their exchange over population. Myers, like many contemporary environmentalists, sees the escalation of human numbers as the overarching environmental threat. The world now houses over 5.5 billion people, a number that increases by nearly 100 million each and every year. Thus far, increases in food production and accumulated wealth may have exceeded the multiplication of people, but, cautions Myers, this has come at a tremendous cost. Today, "there is much evidence that human numbers with their consumption of resources, plus the technologies deployed to supply that consumption, are often exceeding carrying capacity"—the ability of the planet to sustain human existence. As evidence, Myers points to a slowing in global farm output (brought about, in part, by changes in subsidy programs and other government policies), and predicts that agricultural productivity will irreversibly decline as the number of human beings on the planet continues to soar.

Simon, as one would expect, sees the population issue quite differently. He does not accept that "overpopulation" is a real problem, and he feels the data back him up. "There is no basis in the statistics for the belief that faster demographic growth causes slower economic growth," he asserts. The Myers position is based on the Malthusian premise that population will increase exponentially, while increases in food supply climb at a slower rate. If Malthus was right, then the end result can only be disaster. "But if the resources with which people work are not fixed over the period being analyzed, then the Malthusian logic of diminishing returns does not apply," Simon counters. Indeed, humans, unlike other earthly creatures, are not dependent upon an immutable resource base. People are capable of combining "intellectual capital" with physical substances to enrich their lot.

An increase in the number of people represents an increase in the human capacity to solve problems, not just an increase in human wants—and throughout human his-

tory, the force of the former has overcome the drain of the latter.

The Cornucopian-Apocalyptic debate may be alive and well in academic circles, but it is nearly dead in the realm of public policy. The general position espoused by Myers has found its way into environmental and economic policies throughout the modern world, with negative results. "Erroneous belief about population growth has cost dearly," notes Simon. "In poor countries, it has directed attention away from the factor that we now know is central in a country's economic development, its economic and political system." A free society allows for the creative exploration of varied solutions to vexing concerns. Centralized decision-making is more apt to lead to failure. Yet the threat of overpopulation and the need for ecologically sustainable development has become the pretense for a new generation of coercive government controls.

The lesson of Simon's overwhelming array of global statistics is that the world's problems can be surmounted. Human ingenuity has always been the greatest source of hope for the future. According to Simon, "When you develop new technology, build new goods, and expand the scope of our creative activities, you are on the side of the angels—you are promoting human improvement, and the quality of life." It is a lesson the governments of the world need to learn if they are truly concerned with the well-being of their people, and it is a lesson Myers could stand to learn as well. With the publication of this book, there is at least hope for some of the former, if one must give up on any hope for the latter. □

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The Individualist Anarchists: An Anthology of Liberty (1881–1908)

edited by Frank H. Brooks

Transaction Books • 1994 • 310 pages • \$39.95

Reviewed by Gregory P. Pavlik

Anarchism is often associated with the extremes of either capitalist apologetics or communism, particularly by those without even passing familiarity with the subject. Yet, the individualist anarchists defied simplistic categorization from the start. The vast majority of the individualist anarchists did consider themselves to occupy a pole of the socialist movement. At the same time, they variously identified with the egoism of Max Stirner, the individualism of Nietzsche, the anarcho-communism represented by the famous Russian theorist Bakunin, and even the conservatism of Herbert Spencer.

The Individualist Anarchists is a wonderful introduction to this diversity of thought and will be of interest to advocates of limited government as well as students of intellectual history. It consists of representative selections from the principal organ of nineteenth-century individualist anarchism, *Liberty*, which was edited by the best known of the individualist anarchists, Benjamin Tucker. The collection is also an excellent companion to James J. Martin's definitive historical study of early individualist anarchism, *Men Against the State*.

The book is divided into four major sections, each structured to provide a comprehensive exposition of the trends in thought and positions staked out in the pages of *Liberty*. The first section, which occupies a full third of the text, deals with issues of political ideology. The theory of individualist anarchism is based on the principle of "equal liberty," which is described by Tucker as "the greatest amount of individual liberty compatible with equality of liberty." The authors grounded their defense of property rights in a conception of property tied to labor, a position derived from Locke. There is also a substantial amount of

space dedicated to the praises of the free market.

Yet this is hardly the anarcho-capitalism that it seems to be. The writers of this genre were largely preoccupied with the "labor question," and as such an interest might suggest, they saw themselves primarily as socialists. They subscribed to the labor theory of value, and often presented fiery polemics against the bourgeois class.

The second section of the book examines the economics of the individualist anarchists, which dwells on the general theme of labor concerns. However, the individualist anarchists thought that the liberation of the proletariat would be best achieved by the abolition of the "four monopolies": the money monopoly, the land monopoly, the tariff, and the patent or copyright. In practice, this would have meant the elimination of ownership of land by those not occupying and using the soil, and the abolition of intellectual property. Such "evils" as rent and interest would be eliminated, thus bringing the worker into his own. This deviates from the contemporary conception of a free order, in which land functions as property subject to the dictates of the market. Obviously, interest serves an important market function as well.

It is important to emphasize the salient characteristics of libertarian socialism that set it apart from state socialism. To his credit, the editor dedicates a substantial portion of the section on political theory to this issue. For Tucker, the two types of socialism differ in the battle between liberty and authority. State socialism is "the doctrine that all affairs of men should be managed by government," *vis-à-vis* state monopoly. The anarchist position holds to "the doctrine that all the affairs of men should be managed by individuals and voluntary association." Other distinctions were made as well. The writer A. H. Simpson held that "Anarchism is egoism; Communism is altruism." Within the sphere of socialist or labor concerns, the anarchists, as advocates of freedom and self-interest, considered themselves always to be aligned in an antipodal relationship to the state socialists.

The individualist anarchists also carried their conception of freedom into the social sphere. Again, there was consensus, this time in the direction of what is euphemistically known as "free love." In at least one case, a more moderate position of cohabitation with commitment is commended. Many of the writers espoused what might loosely be described as feminist views, although positions on women's suffrage were not taken, as is consistent with a general opposition to the existence of the state. These authors were also generally hostile to religion. Social questions, however, were discussed minimally in the pages of *Liberty*.

Some space, also, was dedicated to the question of strategy (section four), although this too garnered less attention than questions political and economic. It is clear that the individualist anarchists favored non-violence and persuasion as a route to their desired ends. Consequently, they feared "guilt by association" in the wake of the violence at Haymarket Square, Chicago, in 1886 when a police contingent was bombed while attempting to close down a meeting of anarchists. Tucker, for one, attempted to carefully delineate the differences between the violent, "communistic" variety of anarchism and his own concerns with liberty. Whatever the acumen of the individualist anarchists' strategic recommendations, the movement faded, and settled into an ill-deserved obscurity.

Much more complex than a simple precursor to libertarianism or an extension of liberalism, individualist anarchism was a genuine outburst of American radicalism. This volume is recommended to dispel the miasma of disinformation surrounding the movement dealt with in its pages, and as a worthy purchase for any reader with an interest in political theory, American or otherwise. □

Mr. Pavlik is assistant editor and director of The Freeman Op-Ed program.

Demosclerosis: The Silent Killer of American Government

by Jonathan Rauch

Times Books • 1994 • 261 pages • \$22.00

Reviewed by William H. Peterson

Calcification, a kind of spreading dry rot accompanied by a bloating of the body politic, spreads across the American landscape. It's a disease that saps the strength of the people who, ironically, are the ones who demand more and more from a government that gives them, in the end, less and less. The furor over national health insurance is a case in point. The disease reflects the plight of both Politician and Citizen who, like the proverbial maiden of easy virtue, just can't say "No." Ah, democracy!

National Journal contributing editor Jonathan Rauch coins a clever word "demosclerosis" to describe the process. The process is spread by the mushrooming of special-interest organizations who gather virtually every affected and disaffected voter into groups and counter-groups (witness, e.g., the pro-choice vs. the pro-life groups) who pressure Congress and state legislatures to do their bidding. Or else.

It is not a pretty picture nor does it render a pleasant fragrance. As observed by Chancellor Otto von Bismarck of nineteenth-century Germany, the birthplace of the modern Welfare State, anybody repelled by the sight and smell of sausage-making ought not to watch law-making—a process far removed from its nice image projected in high school textbooks on civics.

Mr. Rauch notes that the trick of political success is to fashion special-interest access and accommodation, to gather votes and financial support, to weld blocs and interests—James Madison called them "factions"—together into a winning majority. Hence no program can be cut, no tax break wiped out, no privilege lifted, without provoking the anger of one organized interest or another. The political art is to calm anger and get everybody under the government tent—a tent that eventually gets blown



away. Meanwhile, the budget grows and the dollar sinks, the state swells and the individual shrinks.

Mr. Rauch points out that seven out of ten Americans belong to at least one association, and one in four belongs to four or more. He describes one modest-sized Washington building directory as boasting the following tenants (and there's a lot more beyond the letter C):

Advertising Council
Affiliated Hotels and Resorts
Agudath Israel of America
American Arbitration Association
American Federation of Clinical Research
Americans for Economic Renewal
Center for the Advancement of Health
Congress of Russian Americans
Consortium for the Study of Intelligence

Thus the emergence of America's "parasite economy," its vast lobbying industry centered in Washington, its horde of lawyers with their Gucci loafers and leather attaché cases attending hearings and button-holing Congressmen and bureaucrats who find the attention too sweet to resist. So why resist?

Mr. Rauch credits much of his understanding of how government really works to public choice economist Mancur Olson of the University of Maryland and his 1965 book, *The Logic of Collective Action*. Professor Olson, like Tocqueville before him, sees the mischief of interest-group democracy, sees groups push projects with concentrated benefits and diffused costs—costs foisted on a "rationally ignorant" populace. Free-riding ethanol producers, for example, get Congress to give them a tax break and require Clean Air Act inclusion of ethanol in gasoline so as to "improve the atmosphere." Sure.

For all of the author's sharp analysis of Washington's worldly ways, however, he betrays a kind of fatalistic quality about what to do about rampaging King Kong. He is dubious, to cite an instance, about the term-limit movement which would quash legislative careerists who seek committee

advancement by seniority—adding to "sclerosis." He bemoans the knifing of President Clinton's initiative of "national service" for young people. When Cato chairman and Reagan economist William Niskanen twits Congress, Mr. Rauch responds: "I find much to admire in Congress: it works hard, it means well, it is close to the people, it has done much good." He quotes, approvingly, soothing words from liberals like Jessica Mathews, Jimmy Carter, and John F. Kennedy.

Mr. Rauch wisely says Americans should look in the mirror for key agents of their dilemma. But in the end he calls for not exorcising but "managing"—without really explaining how—the very Superstate that enfeebles and calcifies Americans and their government.

America's challenge, it seems to me, is to sharply scale down the state, return to old-fashioned morality, restore the limited-government model of the Constitutional Framers. The challenge is to get economy back into government, and get government out of the economy. The real democracy, the true empowerment, as Mises pointed out, is in the marketplace. □

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What Went Right in the 1980s

by Richard B. McKenzie

Pacific Research Institute for Public Policy,
San Francisco • 1994 • 397 pages • \$21.95

Reviewed by Raymond J. Keating

If one were to turn to the mainstream media or the current administration in Washington, D.C., as historical guides to the 1980s, one would come to see the decade as a period of great economic decline for the United States. With the decade cast in such a dim light, one also might expect a book entitled *What Went Right in the 1980s* to be a rather slim volume.

In contrast, Richard McKenzie illuminates the so-called "decade of greed." McKenzie provides a detailed look at the fiscal and economic developments of 1980s, chapter by chapter supplanting the political hyperbole so closely associated with the decade with sound economic analysis. Thanks to his efforts, the reader gains a clearer and more sober view of the 1980s. As the author asserts, "The 1980s were not the best of times; the decade could have been better. But, neither were they the worst of times. On balance, the decade was a pretty good one."

McKenzie provides much evidence to back up his declaration. The most substantial is that "growth in U.S. output during the 1980s was the equivalent of adding the entire economy of Germany (East and West) or two-thirds of the Japanese economy to the U.S. economy." Based on this fact alone, one would be justified in declaring that the economy of the 1980s was more than just pretty good.

The author addresses a host of issues that have been hotly debated, including the trade deficit. Critics argue that a growing trade deficit reflects a waning ability to compete on the world economic stage. McKenzie deftly counters such misguided notions with two key points:

First, one reason for the rise in the U.S. trade deficit in the 1980s is the faster pace of economic growth in the United States compared to that of most other countries around the world. With a more rapid rate of growth, producers need more resources, many of which must be drawn from abroad in the form of imports. . . . Second, the balance on the capital account necessarily mirrors the balance on the trade account (with adjustments for other elements in the overall balance of payments). This means that exports are not the only U.S. products that foreigners want. As was evident in the growing balance of the capital account surplus in the 1980s, foreigners also wanted capital goods that could be put to work in this country.

McKenzie concludes: "In other words, the trade deficits could have (and did to an extent) reflected the fact that American exporters of goods were simply out-competed, not by foreign producers but by domestic producers of investment opportunities in the United States."

Another favorite criticism of the decade was a worrisome increase in private debt. However, individuals levying such concerns fail to view both sides of the equation. As McKenzie notes: "Debt, which is merely a claim on assets, is no burden at all when it is used to acquire assets that are at least equal in value to the collateral assets." He goes on to observe that, in fact, private assets rose more rapidly in real terms during the 1980s than did private debt, hence "yielding an increase in total private net worth."

McKenzie even manages to find a bright side to mounting government debt during the 1980s. Interestingly, he notes that "deficits may be 'bad' in themselves, but that does not mean that they were the worst thing to do under the political and economic circumstances of the 1980s." Though some may disagree with McKenzie's assessment of government debt, I believe his arguments hold merit, and at the very least, provide the basis for spirited debate.

McKenzie attacks other misconceptions regarding the 1980s. For example, during the so-called "decade of greed," the annual rate of growth in total real charitable giving was almost 55 percent higher than in the previous two-and-one-half decades. As for some individuals benefiting during the 1980s at the expense of others, McKenzie's income and expenditure analyses reveal that "the rich, poor, and middle classes got richer in real dollars and that their gains showed up in the amount of goods and services they bought."

What Went Right in the 1980s acts as a substantive counterweight to the mounting attacks on the economic record of the 1980s. McKenzie proves to be a good writer and innovative economic thinker. In his concluding chapter, he takes a peek at the 1990s, and offers this simple, yet sage ad-

vice: President Clinton "should look to the tax theory of his mentor, John Kennedy, who proposed to lower tax rates for the same reason Ronald Reagan did: High tax rates represent a drag on the economy." □

Mr. Keating is the director of New York Citizens for a Sound Economy and partner with Northeast Economics and Consulting.

Separating School and State

by Sheldon Richman

The Future of Freedom Foundation • 1994 •
128 pages • \$22.95 cloth; \$14.95 paperback

Reviewed by George C. Leef

Sheldon Richman bases his case against government education on its philosophical incompatibility with a free society and its inherent inability to produce results as good as a free market in education would produce. His strategy may well win more converts to freedom's side and win them more quickly than the strategy that begins with an effort to prove that public schools are declining. When a Gerald Bracey rushes to the defense of public education with a statement such as "American schools have never achieved more than they currently achieve," the rebuttal should be that it doesn't matter whether that is true or not. We should argue, as Richman does, that public education has and always will underperform because it severs the link between satisfied customer and revenue for the provider. For anyone who is going to be debating this issue, Richman's book is a gold mine full of attacks and counterattacks that will leave statist opponents spluttering.

One of Richman's most penetrating points is that the traditional idea of schools as developers of young human beings is flawed. Members of the education establishment see their role as shaping children, which almost invariably entails molding them into obedient servants of the state. Richman challenges that idea. "[S]chools do not—and should not—develop human

beings. It has long been popular to think of education that way. That, I believe, is wrong. Human beings develop themselves—if they develop at all. To grow, children need assistance; specifically, they need information and good examples from adults. But they do not need adults or institutions to develop them into human beings. This is not just semantics. The common conception of education casts children in a fundamentally passive role. They are empty vessels that only adults with special skills—teachers—can fill."

How, then, should we view education? Richman answers, "Education should be seen as a way of encouraging the child's natural curiosity. That change in focus automatically makes the child the active party in the enterprise. Children come into the world thirsting for knowledge about their surroundings. The educational process needs only to abstain from killing that curiosity. Each child is unique. The last thing he or she needs is a procrustean school. The things that interest politicians and educational professionals, such as national standards, are so many distractions."

That, of course, is precisely why we must separate school and state. People cannot find the optimal ways of educating children if they are constrained by laws, taxes, and regulations. Free economies are always coming up with new products that serve people's wants while centrally planned ones inhibit progress and leave people with a lifetime of "take-it-or-leave-its." (Can anyone name one product that makes life more pleasant that originated under Communism?) A free market in education would maximize each parent's ability to find the kinds of educational services that are best suited to his children.

Richman gives readers an enlightening overview of the history of American education. He points out that American society was highly literate in the late eighteenth and early nineteenth centuries, prior to the advent of tax-financed schools and compulsory education laws. It took the enemies of freedom several decades to get their foot in the door, but by the 1840s, the first public

school systems had been established in the United States, modeled after the authoritarian Prussian system. There was no widespread public dissatisfaction with our educational free market, but a small number of influential "reformers" wanted to try their hand at shaping the youth of the nation. Youngsters would be taught, first and foremost, what to think, to be obedient citizens, to pay taxes and fight wars when commanded to. If children happened to learn how to think, that was beside the point.

Richman devotes a chapter to the arguments of opponents of public education. This chapter, one of the most useful in the whole book, is chock full of quotable material from great thinkers who foresaw the dangers of statist education. The famous English scientist Joseph Priestley was an opponent, as were the German philosopher William von Humboldt and English philosophers Herbert Spencer and Auberon Herbert. Richman also gives American critics their due. This chapter allows the reader to

see how little the debate has changed over a period of nearly two centuries. Most of the objections to public education which are voiced today were made long ago; most modern arguments in its defense were refuted long ago.

Richman convincingly argues that nothing short of the complete depoliticization of education will rescue it from its current degraded state. He contends that the proposals, supported by many free marketeers, for vouchers, contracting out, charter schools, and other marginal reforms will do little if any good as long as the state is still the major player in the field of education. We need to stop wasting our efforts on trying to untie the Gordian Knot of public education. There is but one solution to the crisis: the tie between school and state must be cleanly cut. □

Mr. Leef is Legislative Aide to State Senator David Honigman of Michigan and an Adjunct Scholar with the Mackinac Center for Public Policy in Midland, Michigan.

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